

RESCISSION OF REAL ESTATE CONTRACTS

I. WHAT IS RESCISSION?

- A. **Contract Remedy:** Rescission is a remedy that *disaffirms* the contract. The remedy assumes the contract was properly formed, but effectively *extinguishes* the contract *ab initio* as though it never came into existence; and its terms cease to be enforceable.
- B. **Inconsistent with Breach of Contract Remedies:** Rescission is predicated on a *disaffirmance* of the contract, thus it is inconsistent with a damages suit for breach of contract or fraud, a reformation suit, or a specific performance suit, all of which effectively *affirm* the contract.
- C. **Inconsistent with Lack of Contract Formation:** A finding that there *never was a meeting of the minds* on the essential terms—i.e., that the parties *lacked contractual intent*—means that *no contract was formed* and there is *no* remedy of rescission.

II. GROUNDS FOR RESCISSION

- A. **Mutual Rescission:** Rescission of a contract may be effected by mutual consent of all parties to the contract. Mutual rescission can be effected without litigation.
 - 1. **Written, oral or implied:** The parties' consent need not be in writing, even if the contract to be rescinded was required by the statute of frauds to be in writing. A consensual rescission may occur by the parties' *oral* agreement; or it can be *implied* from their unequivocal conduct that is inconsistent with continued existence of the contract.
 - 2. The parties enter into a new agreement to terminate the old agreement. To accomplish an effective rescission, there must be evidence of the traditional requirements for the creation of a contract: an offer and acceptance, a mutual assent, a meeting of the minds on the terms of their agreement, consideration, and an intent to rescind the former agreement on the part of both parties.
 - 3. **Oral agreement to rescind written contract.** There is a distinction between an alteration or modification of a contract, which retains the legal effectiveness of the contract as modified, and a rescission, which terminates the contract. The requirement that a contract in

writing may be altered or modified only by a subsequent writing or an executed oral agreement does **not** apply to a subsequent agreement to rescind or abandon the contract, because an abandonment or rescission is a termination of the contract and not an alteration or modification. A rescission is an agreement to end the prior agreement in its entirety and not an agreement to alter or modify only a part of the agreement. Therefore, even when there is a written contract that is required to be in writing under the statute of frauds, the parties can enter into an oral agreement to abandon or rescind the contract without any written memorandum or confirmation of their agreement to rescind, and the oral agreement effectively abrogates their prior contract, whether the rescission agreement is executed or executory.

B. Unilateral Rescission: When mutual rescission cannot be negotiated. Results in litigation seeking rescission.

1. Mistake of Fact: An erroneous belief about an *objective* existing or nonexisting fact *material* to the contract.

a. Consent given under mistake of fact: when, not because of his or her “neglect of a legal duty” he or she:

(i) Is ignorant of or has forgotten a past or present fact material to the contract, or

(ii) Believes in the present existence of something material to the contract, that does not exist, or in the past existence of something that never existed.

b. Unconscionability: Only authorized where the effect of the mistake is such that enforcement of the contract would be *unconscionable*.

c. No requirement that the non-rescinding party caused or even knew of the mistake. [See Rest.2d Contracts § 153(a)]

d. Rescission not available for party who bears risk of mistake: Rescission is unavailable to a contracting party who bears the risk of the mistake at issue. A party bears the risk of a mistake when:

- (i) The risk is allocated to the party by the contract; or
- (ii) The party is aware when the contract is made that he or she has only limited knowledge regarding facts to which the mistake relates, but treats that limited knowledge as sufficient; or
- (iii) It is reasonable under the circumstances to allocate the risk to the party.

Example: *6 Angels, Inc. v. Stuart-Wright Mortg., Inc.* (2001) 85 Cal.App.4th 1279, 1287-1288.

Case Summary: A loan servicer conveyed the wrong minimum bid amount for a foreclosure sale (\$10,000 instead of \$100,000). The trial court granted the purchaser summary adjudication on its claim to quiet title, after the purchaser was the successful bidder at \$10,000.01. The court of appeal affirmed the lower court's decision, holding that the loan servicing company was not entitled to rescind the contract on the basis of unilateral mistake because a beneficiary is deemed to assume the risk of obtaining an inadequate price at a foreclosure sale. "Unless beneficiaries assume the risk of such errors, a low opening bid at a foreclosure sale will invariably trigger suspicion about the sale's finality, deterring buyers and impairing the efficacy of foreclosure sales." Further, the error was wholly in the loan servicer's control and arose from its own negligence.

2. Mistake of law: A mistake of law occurs when a party to the contract knows the facts as they actually are but has a mistaken belief as to the *legal consequences of those facts*.

a. A mistake of law entitles a party to rescission only where:

- (i) All parties think they know and understand the law but all are mistaken in the same way; or
- (ii) One side misunderstands the law at the time of contracting and the other side knows the correct law but does not rectify the other party's misunderstanding.

b. Subjective misunderstanding of contract not enough: The fact that one of the parties subjectively misunderstood his or her contractual duties or other contractual terms, or that both

parties had differing subjective understandings of the contract from its inception, does not warrant rescission based on mistake of law.

- c. **“Neglect of legal duty” no bar to relief:** Unlike cases where a party’s “neglect of a legal duty” precludes rescission or reformation based on a mistake of fact, “freedom from negligence” is *not a prerequisite* to rescission based on a mistake of law.

3. **Duress/Undue Influence:** Courts consider a variety of factors in determining whether the rescinding party’s consent was procured through duress or undue influence, including:

- a. **The adequacy of the consideration involved;**
- b. **Whether the rescinding party acted with a free mind;**
- c. **Whether the contract was negotiated at arm’s length; and**
- d. **Whether the parties to the contract were in a confidential relationship** – Most commonly arises between attorneys and clients, principals and agents, trustees and beneficiaries. However, confidential relations may exist whenever there is a relationship based on trust and confidence.

Example: *Kloehn v. Prendiville* (1957) 154 Cal.App.2d 156, 161.

Summary: Plaintiff, a 63 year old man, invited the defendants to move into his home with him, based on the understanding that they would provide his meals, do his laundry, etc. and they would have no rent or other financial responsibilities with respect to the property. He also agreed that he would devise the property to them in his will. Two years later, while the plaintiff was recovering from an operation under the care of the defendants, they convinced him to execute a deed conveying the property to them, subject to the condition that they would continue to provide him with room and board for as long as he lived. Defendants executed a promissory note for \$5000 without interest payable to plaintiff. Defendants also convinced plaintiff to execute an agreement providing that he would be charged \$50 a month for his room and board, which would be credited upon the note, but at his death any unpaid balance would be deemed fully satisfied and discharged. They induced him to sign this agreement by assuring him that the document was in lieu of his will. After the note was paid in full, Defendants informed Plaintiff that they were the owners of the property and plaintiff would have to

pay room and board if he wanted to live there. Plaintiff disputed Defendants' title to the property, moved out and filed an action for rescission.

Several factors in this case supported Plaintiff's grounds for rescission: (1) adequacy of consideration, only \$5000; (2) Plaintiff was recovering from surgery when signing the deed and agreement; (3) the court found that the parties were in a confidential relationship, finding that although the parties were not related, they had "established a de facto family." The Plaintiff testified that he trusted and had confidence in the Defendants and believed that they would give him a home as long as he lived. The court further held that the plaintiff's negligence in failing to read the contract does not bar his right to relief if he was justified in relying upon the representations.

4. Fraud

- a. **Actual Fraud:** misrepresentation made with intent to deceive
- b. **Constructive Fraud:** misleading conduct without fraudulent intent to the prejudice of the other party. A presumption of constructive fraud may arise where there is inadequate consideration for the rescinding party's performance and especially where the parties are in a confidential relationship. [See CC § 1572 (defining "actual fraud") & § 1573 (defining "constructive fraud")]
- c. **Fraud in the inception:** If fraud goes to the execution or inception of a contract so that parties do not know what they are signing, the contract lacks mutual assent and is void. Thus, the contract may be disregarded *without the necessity of rescission.*
- d. **Fraud in the inducement:** Where parties know what they are signing but their consent is induced by fraud, mutual assent is present and a contract is formed that, by reason of the fraud, is voidable. Under these circumstances, *a party seeking to void the contract must rescind.*
- e. **Can be based on an innocent misrepresentation:** Even an innocent misrepresentation, made in good faith and with a reasonable belief in its truth, may provide a basis for rescission if it related to a material fact upon which the rescinding party relied in consenting to the contract.

Example: *Thrifty Payless, Inc. v. Americana at Brand, LLC* (2013) 218 Cal.App.4th 1230, 1243-1244

Summary: Plaintiff Thrifty Payless, Inc. was a tenant of defendant The Americana at Brand LLC shopping center. Negotiations held through letters of intent before the execution of Thrifty's lease contained Americana's per square foot estimates concerning Thrifty's probable pro rata share of property taxes, insurance, and common area maintenance (CAM). The final lease stated that Thrifty would pay its pro rata share of such expenses and did not contain any formulas, figures or percentages regarding Thrifty's share of such expenses. After Thrifty moved into the shopping center, its share of these expenses substantially exceeded Americana's estimates and Thrifty sued for fraud, rescission based on mutual mistake and mistake of fact, and breach of lease and breach of the implied covenant of good faith and fair dealing. The trial court granted Americana's demurrer and the Court of Appeal reversed holding that —while no tort liability exists for “innocent misrepresentation,” a shopping center lease was subject to rescission where neither party knew common expense estimates made by lessor’s agents before execution were grossly inaccurate.

- f. **Can be against innocent “conduit”:** Being in the nature of an equitable remedy, rescission may lie in an appropriate case against a contracting party who was simply the *conduit* through whom a *third party’s* fraud was perpetrated upon the plaintiff. Although entirely innocent of any wrongdoing, the “conduit” is a “necessary party” to the action “because, in its absence, complete relief in the form of rescission cannot be accorded to plaintiff ...” [

Example: *Shapiro v. Sutherland* (1998) 64 Cal.App.4th 1534, 1551-1552.

Summary: Buyer purchased a home from a relocation assistance service to whom Sellers sold their home *knowing* it would immediately be resold to another. Sellers had represented to the relocation service that there were no noise problems in the neighborhood, when in fact there were serious noise disturbances from the next-door neighbors, and the relocation service innocently passed this representation onto Buyer. The Buyer’s right of rescission could not lie against Sellers, who had perpetrated the fraud, because Buyer’s contract of purchase and sale was with the relocation service to whom Buyer had paid the purchase price and thus from whom Buyer had to seek return of that consideration. Despite the fact that the relocation service was an innocent party, it was a necessary party to the action to the extent that the Buyer sought the equitable remedy of rescission.

g. **Opinions re property value are not actionable:**

- (i) Statements concerning the value of property are generally deemed to be expressions of personal opinion and not actionable representations of fact upon which the other party can rely.
- (ii) Conclusions as to how the legal or practical ramifications of disclosed facts adversely impact value are not facts subject to a duty of disclosure.

5. **Failure of Consideration:** A contract may be rescinded for failure of consideration in three situations:

- a. Where the consideration for the rescinding party's obligation *fails*, in *whole or in part*, through the *fault of the other party* to the contract;
- b. Where the consideration for the rescinding party's obligation becomes entirely *void from any cause*; or
- c. Where the consideration for the rescinding party's obligation *fails* in *a material respect from any cause before it is rendered*.

6. **Illegality:** A contract may be rescinded if it is unlawful for causes which do not appear in its terms and conditions and the parties are not equally at fault.

Example: *Yuba Cypress Housing Partners, Ltd. v. Smith* (2002) 98 Cal.App.4th 1077, 1081—plaintiff rescinded real estate contract with defendant developer on ground of illegality after discovering defendant violated Subdivided Lands Act.

Example: *Lund v. Cooper* (1958) 159 Cal.App.2d 349, 351-352—purchase agreement calling for sellers to complete construction of incomplete dwelling on property was rescindable by buyer on ground of illegality because sellers were not licensed contractors as required by law.

7. **Public interest:** A party may rescind a contract where its enforcement would be prejudicial to the public interest.

8. **Catch-All:** California law provides for a “catch-all” provision recognizing a party's right to rescind under “any other statute providing for rescission.”

[See CC § 1689(b)(7)] Some California statutes specifically grant buyers the right to rescind a real property purchase contract:

Example: Gov. C. § 66499.32 allows a buyer to rescind a real property contract that is in violation of the Subdivision Map Act at any time within one year after discovery of the violation.

III. NOTICE REQUIREMENT

A. Prompt Notice Required: A party intending to effect a unilateral rescission must *give notice* to the other party *promptly upon discovering the facts* entitling him or her to rescind (provided the aggrieved party is “free from duress, menace, undue influence or disability” and is aware of the right to rescind at that time). [CC § 1691(a)]

1. Action for Rescission: If non-rescinding party refuses to rescind, the rescinding party is entitled to bring an action to *obtain relief* based upon the rescission (or, viewed another way, an action to *enforce* the rescission).

2. Service of pleading as notice: Although technically a prerequisite to filing suit based upon rescission, if the notice has not otherwise been given, plaintiff’s *service of a pleading seeking rescission* (i.e., a complaint) “shall be deemed to be” the requisite notice. [CC § 1691]

B. Waiver:

1. Delay in Providing Notice: delay in providing timely notice will amount to a waiver of the right to relief based on rescission *only* if the delay has *substantially prejudiced* the other party. [CC § 1693]

Example: *DM Residential Fund II, LLC v. First Tennessee Bank Nat’l Ass’n* (9th Cir. 2015) 813 F3d 876, 877

Summary: Plaintiff’s two-year delay in pursuing rescission after purchasing a foreclosed residential property that, among other things, lacked a utilities easement resulted in summary judgment in the seller’s favor. The court found that “[i]nstead of investigating and pursuing its claims, [plaintiff] took actions inconsistent with unwinding the contract, including encumbering the property, building improvements, and attempting to sell it. By taking those actions and waiting two years before suing [defendant], [plaintiff] affirmed the transaction, and its right to rescind it is gone.” remedy of rescission.

Example: *McCray v. Title Ins. & Trust Co.* (1936) 12 Cal.App.2d 537, 538-542 – Buyers purchased a beach lot in Los Angeles County based on the representations of the sellers that the installation of “groynes” along the beach would have the effect of increasing the log depth over two to three times. The evidence showed that the buyers became aware that the lot was not being built up or increased in depth within one year from the date they entered into the contract, but the buyers did not take any action toward rescinding for more than two years thereafter. Buyers waived their right to seek rescission by making payments on the purchase price of a beach lot for over two years after learning of the seller’s misrepresentation and before giving notice of rescission.

2. **Inconsistent Conduct:** A party may waive the right to rescind by words or actions indicating an affirmation of the contract after learning of the facts entitling him or her to rescind.

Example: *Beason v. Griff* (1954) 127 Cal.App.2d 382, 391— Buyers were seeking a property for the purpose of operating a boys’ camp and intended to build a swimming pool and dormitory on the premises. A memorandum was given to the buyers that indicated there was a well adjacent to the trailer, which in normal years should supply 5,000 or more gallons of water per day. It went on to say that the well is not being used, but the quality of the water is good, and a small pump and pressure tank would make it available for irrigation. Prior to the close of escrow, the well was tested and there was evidence that the buyers knew that it was unfit for domestic use or consumption, but they signed the escrow instructions and deposited the deed of trust in escrow after learning of the condition of the water and the misrepresentation that the “water is good.” The court found that the buyers had waived the right to rescind by signing escrow instructions and depositing deed of trust after learning of the fraud.

a. **No waiver if affirmation induced by fraud:** There is no waiver if the acts indicating affirmation of the contract were induced by the other party’s fraud.

b. **No waiver if affirmation after rejection of rescission:** Continued acceptance of the benefits of the contract after giving notice of rescission does not waive the right to relief based upon rescission if the other party has rejected the notice of rescission. The rescinding party may continue to accept the benefits until the action for rescissionary relief is concluded.

c. **No waiver by seeking breach of contract damages in the**

alternative: A party does not waive the right to rescind by bringing an action based upon rescission *or* damages for breach of contract *in the alternative*. Though the remedies are inconsistent (rescission disaffirms the contract, while a damages suit affirms it), the aggrieved party is not put to a final election of remedies until after a trial upon presentation of the evidence.

- C. **Federal Truth in Lending Laws (TILA):** Under TILA, homeowners have an *unconditional* right to rescind their home loans upon *three days' notice*, after which they may rescind only if the lender fails to satisfy TILA's disclosure requirements. This conditional right expires *three years* after the transaction is consummated or the property is sold, whichever comes first. [15 USC § 1635(a), (f)]

TILA gives homeowners an opportunity to think about their mortgage, or the refinancing of their mortgage, even after signing the documents. When refinancing a mortgage, the borrower has three days, commonly referred to as a "3-day right of rescission," to change their mind. The 3-day rescission period ends at midnight three business days after the loan documents were signed. If the borrower decides to cancel the loan within the rescission period, any fees paid in relation to the loan are to be refunded by the lender. The 3-day right of rescission provision of the Truth in Lending Act is intended to protect consumers, who often are overwhelmed by the amount of legal jargon, and loan terms they are unfamiliar with.

IV. RESTORATION OF CONSIDERATION

- A. **Rescinding Party must Promptly Restore, or Offer to Restore Consideration:** In addition to giving prompt notice of rescission, the party seeking rescissionary relief must "promptly," upon discovering the facts entitling him or her to rescind, *restore* to the other party "everything of value" received under the contract or *offer to restore* the benefits received "upon condition that the other party do likewise" ... *unless* the other party "is unable or positively refuses to do so." [CC § 1691(b)]
1. **Real Property Transactions:** In a real property purchase and sale transaction, a rescission normally requires the buyer to return the property (title) to the seller and the seller to return the funds received from the buyer.
 2. **Service of pleading as offer to restore:** Although notice and an offer to restore were required under common law. In many

jurisdictions, such as California, a formal offer to restore the contractual benefits received is not required. Plaintiff's *service of a pleading seeking rescissionary relief* (i.e., a complaint) "shall be deemed" to be the requisite offer. [CC § 1691]

3. Pleading Requirements: The following must be alleged in an action for rescission:
 - a. The existence of a contract
 - b. Grounds for rescission (if fraud, for example, must be plead with specificity)
 - c. If based on failure of consideration, plaintiff must plead its own performance under the contract.
 - d. At common law, were required to plead notice of rescission and an offer to restore. Some jurisdictions no longer require this, and the service of a pleading seeking rescission is deemed the notice, or offer, or both.

B. Exceptions

1. **No value received:** An offer or restoration of benefits is not required where the rescinding party received no benefits under the contract.
2. **Restoration impossible:** Where, through no fault of the rescinding party, restoration would be impossible, the court can otherwise adjust the equities between the parties.
3. **Other inequity:** As rescission is an equitable remedy, courts may decide that an offer to restore the benefits received is not required where it otherwise would be "inequitable"

Example: *Farina v. Bevilacqua* (1961)192 Cal.App.2d 681, 684-685.

Summary: Buyers acquired a 20-foot strip bordering Seller's land on the representation they wanted to dedicate the strip to County for use as a road. In fact, Buyers conveyed only an 18-foot strip to County and retained the balance, which separated Seller's land from the road, for the purpose of cutting off Seller's access. Though Buyer's irrevocable conveyance to County precluded their restoration to Seller of the entire 20-foot parcel, partial rescission restoring the two-foot parcel to Seller and returning a pro rata share of the purchase price to Buyers was properly granted. "Where a

defendant has been guilty of fraud, courts of equity are not so much concerned with decreeing that defendant receive back the identical property with which he parted ... as they are in declaring that his nefarious practices shall result in no damage to the plaintiff.”

- C. **Waiver:** As with the notice of rescission, a delay in restoring benefits received under the contract or in tendering such restoration does *not waive* the right to relief based upon rescission *unless* the delay *substantially prejudices* the other party.

III. DAMAGES

- A. **Damages Not Required:** Unlike breach of contract or fraud case, defrauded party has the right to rescind a contract even without a showing of damages. This is based on the basic principle that a contracting party has a right to what it contracted for, and therefore has the right to rescind where the party obtained something substantially different from that which contracted for.
- B. **Damages Available:** The damages available in rescission cases depends on the reasons for which the contract was rescinded. For example, damages obtainable in actions for rescission based on the *nonrescinding party's fault* (e.g., cases involving fraud or misrepresentation) are more expansive than those not involving fault (e.g., mistake), and may include consequential damages and even punitive damages.
1. **Consequential damages:** Consequential damages in the rescinding party's favor may include all out-of-pocket expenses incurred in reliance on the contract—including, e.g., real estate commissions, escrow fees, title charges, interest on specific sums paid to the other party, the value (or cost) of any improvements made to the property, payments made by a rescinding buyer on a mortgage imposed by the seller, and attorney fees (if authorized by the rescinded contract).
 - a. **No “benefit of bargain” damages:** Consequential damages in a rescission case are those that would *restore the parties to their original positions* and do not include breach of contract “benefit of bargain” damages.
 2. **Interest:** A rescinding buyer is entitled to prejudgment interest on contract payments made to the seller (net of liquidated offsets awarded to the seller), running from the date of notice of the

rescission.

3. **Punitive damages:** Where the rescission is based upon fraud, and the plaintiff satisfies the applicable statutory standards for punitive damages, the court has discretion to award the rescinding party punitive damages.

- C. **If Rescission Not Successful, Contract Remedies Available:** In the event the court determines the contract was not effectively rescinded, it may grant the other party whatever relief he or she may be entitled to under the circumstances. [CC § 1692]

IV. CASES WHERE RESCISSION IS NOT AVAILABLE

- A. **Tax-Defaulted Property:** Rescission and other common law contract remedies are *not available* to buyers of tax-defaulted real property at public auction (Rev. & Tax.C.). The buyer's exclusive remedies are prescribed by statute:

1. Buyer's remedies limited to a refund of purchase money paid *only* where the court determines the tax deed is void (Rev. & Tax.C. § 3729) or the property should not have been sold (Rev. & Tax.C. § 3731).

Example: *Ribeiro v. County of El Dorado* (2011) 195 Cal.App.4th 354, 356-357—investor who mistakenly bought real estate from public entity at tax sale without knowing bond arrearage amount was limited to statutory remedies and not entitled to rescind.

Example: *L&B Real Estate v. Housing Auth. of County of Los Angeles* (2007) 149 Cal.App.4th 950, 959 - refund sole remedy available to purchaser of public property mistakenly conveyed for nonpayment of taxes (tax deed was void because public property is exempt from taxation)