

# Client Alert

An informational newsletter from Goodwin Procter LLP

## Recent California Decision Suggests Buyers Should Provide Non-Refundable Consideration In Certain Purchase and Sale Real Estate Transactions

With respect to a real estate purchase and sale agreement in which the buyer has the unfettered right to terminate the contract during the due diligence review period, states have differed as to whether the buyer must provide the seller with non-refundable consideration in order to avoid an illusory contract. The state of California has previously not required such consideration, but a recent case, *Steiner v. Thexton*, 163 Cal.App.4th 359, 77 Cal.Rptr.3d 632, Cal.App 3 Dist., 2008, has called that position into doubt by requiring that a buyer provide such consideration or potentially find that it has entered into an illusory contract that will not be enforced.

Since buyers in real estate purchase contracts are typically provided with certain termination rights during their due diligence review periods, this decision is of particular importance. Failure to provide non-refundable consideration to the seller in such circumstances could render the contract unenforceable in the event that the seller decides to terminate the contract because the “option” (*i.e.*, the right to terminate for any reason or no reason) will be considered a continuing offer that is freely revocable. Consequently, as discussed below, in the representation of buyers in California, it is now of great importance to provide non-refundable consideration to the seller in order to ensure enforceability of the contract when the buyer retains an unfettered right to terminate the contract.

### **The *Steiner* Decision and Rationale**

In *Steiner*, the plaintiff, a real estate developer, sought to purchase and develop several residences on a portion of the defendant’s land. As alleged by the plaintiff, the contract consummated between the parties provided for the defendant to sell the land to the plaintiff for \$500,000 within approximately three years, if the plaintiff decided to purchase the land after expeditiously pursuing, at his own expense, required county approvals and permits. The plaintiff, however, was not obligated to make such efforts and could abandon the project upon notice to the defendant and delivery of any work performed up to the time of the notice. The contract also stipulated that the plaintiff make a \$1,000 deposit into escrow, applicable to the purchase price, upon execution by the defendant. The contract provided that the plaintiff had until the closing of escrow to obtain all of the necessary approvals needed for his planned development, and that the plaintiff may, at his sole and absolute discretion during such period, elect not to continue the transaction and thereby render the contract null and void.

After the plaintiff began pursuing the necessary county approvals, the defendant determined that he no longer wanted to sell the property and asked the title company to cancel escrow, whereupon the plaintiff filed suit for specific performance under the contract. The trial court held for the defendant, determining that the contract was unenforceable because it constituted an option contract not supported by consideration. The court construed the contract as an option contract because the defendant bound himself to sell the property for a stated price within a certain time frame while the plaintiff retained the sole and absolute discretion to elect to terminate the transaction. The court also found that the defendant had received no consideration for his grant of the option. In particular, the court noted that the deposit did not qualify as consideration for the option because such payment was applicable to the purchase price rather than the grant of an option and would not be retained by the defendant upon any termination. Furthermore, the work done and expenses incurred by the plaintiff in pursuing the development did not suffice as consideration, even though the plaintiff was obligated to deliver any and all work product to the defendant. The plaintiff retained the right to terminate the contract at any time, and consideration must be measured as of the time of execution of the contract. The court likewise rejected the plaintiff's contention that promissory estoppel should apply to enforce the contract, finding that the plaintiff's actions subsequent to the execution of the contract were not tied to the consideration necessary for the option itself and the plaintiff retained the ability to terminate the contract at any time.

The appellate court upheld the ruling of the trial court. More specifically, it rejected the plaintiff's argument that his promise to act expeditiously in pursuit of county approvals and his continued investigation of the property constituted consideration, noting that such actions were unenforceable promises since the plaintiff was not required to take any actions at all. In addition, the plaintiff's delivery of any obtained information to the defendant in the event of termination was not consideration because it did not impose any legal obligation upon the plaintiff, who was free to back out of the transaction at any time without doing any studies or pursuing any necessary county approvals. Finally, the appellate court rejected the application of promissory estoppel, determining that the balance of equities favored the defendant because the plaintiff retained the ability to walk away from the contract at any time, and any ambiguity would be construed against the plaintiff, as the drafter of the contract.

### **The Changed Landscape and Its Practical Effects**

The *Steiner* case sets forth a significant shift in the enforceability of real estate purchase contracts that provide the buyer with an unfettered right to terminate the contract under California law. It should be noted, however, that the contract in *Steiner* effectively provided the plaintiff with a due diligence period that extended until the close of escrow. In a more typical scenario, the due diligence period (and buyer's concomitant right to terminate) will expire at some definitive date prior to closing. Thus, the contract would presumably be enforceable at the expiration of the due diligence period as the buyer's option to terminate at no cost could no longer be exercised.

While the *Steiner* case does not address this issue, it would appear that a buyer's right to terminate the contract because of the failure of a condition to close (*e.g.*, breach of a representation, failure to issue a title policy) will not be construed as an option if the contract provides that the buyer's right to terminate is restricted to the failure of a condition outside of the buyer's control.

Given that many real estate purchase contracts provide buyers with an unrestricted right to terminate during the due diligence period, practitioners representing buyers of real estate under contracts governed by California law must carefully review the contract to determine if their clients have the unfettered right to terminate the transaction. If there is such a provision, it is advisable that an initial option payment that is non-refundable under any and all circumstances be included in the contract, providing that the buyer will make a payment to the seller to serve as consideration for the seller's removal of the property from the market and the buyer's absolute right to terminate the contract. In states that have required such consideration, the initial payment is typically between \$100 and \$1,000.

If you would like additional information about the issues addressed in this client alert, please contact:

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