

FUTURE REAL ESTATE CONTRACTS WILL BE AFFECTED BY SUPREME COURT RULING

Author(s): Trainor Fairbrook

The California Supreme Court's long-awaited decision last Thursday in the case of *Steiner v. Thexton* has come as somewhat of a surprise and will likely result in changes to the way the parties to a real estate contract address certain due diligence obligations. It has been common practice for the buyer in a real estate contract to have the right to investigate a property for a stated period of time, with an almost unfettered right to terminate the contract in the event the buyer is dissatisfied. Few, if any, thought that this would also give *the seller* the right to terminate the agreement during the buyer's inspection period. However, that is exactly what happened until the California Supreme Court overruled the lower court's opinion last week.

Martin Steiner, a real estate developer, approached Paul Thexton in 2003 about purchasing ten acres of a 12.29-acre parcel of land located in Sacramento County. In order to consummate the purchase, the property would have to be subdivided so that Thexton could retain approximately two acres. The parties agreed that Thexton would sell Steiner the ten acres if Steiner obtained the parcel map and any other approvals or permits. Importantly, Thexton purportedly rejected an offer from a different party for \$250,000 more because that buyer wanted Thexton to process the parcel map. Steiner and Thexton signed a "Real Estate Purchase Contract," giving Steiner three years to obtain the approvals or terminate the agreement. During the following year, Steiner expended approximately \$60,000 in processing the parcel map. During this time, Steiner still retained the right, at his "absolute and sole discretion," to terminate the contract. In the late summer of 2004, almost a year after the parties signed the contract, and after Steiner had expended substantial time and money pursuing the approvals, Thexton cancelled escrow and told Steiner that he no longer wanted to sell the property. Steiner then sued for specific performance, trying to force Thexton to sell the property to him.

The trial court held that Steiner could not enforce the agreement with Thexton because it

deemed the Real Estate Purchase Contract to be an “unenforceable option.” Steiner appealed to the California Court of Appeals and lost. He then appealed to the California Supreme Court.

The California Supreme Court addressed the case as a two-part issue. First, the Court found that the contract signed by Steiner and Thexton was an “option” contract rather than a purchase agreement because Steiner could back out at any time. Second, the Court found that, although there was not sufficient consideration to make the contract enforceable at the time the contract was signed, Steiner’s actions in obtaining the approvals and spending \$60,000, benefitted the Seller by splitting off the two acres. Therefore, those actions constitute part-performance, rendering the option irrevocable such that Thexton could not terminate the contract.

In holding that the Real Estate Purchase Contract was an “option” agreement, the Court reasoned that the agreement contained the “classic feature[s] of an option” because the contract required Thexton to hold open an offer to sell the property at a fixed price for a fixed period of time and because Steiner had the right to “terminate at any time for any reason.” The Court distinguishes this situation, where Steiner could terminate the agreement even if all the contingencies were satisfied, with a real estate contract where termination is permitted only if a contingency fails. The Court found in this case that the “unfettered power to withdraw at any time for any reason” overrode any other obligations that Steiner might have had to expeditiously pursue the approvals.

Since the Court found that the contract was an “option” agreement, it could be terminated by either party unless there was some consideration paid by the buyer that would render it irrevocable by the seller. In this case, Steiner was rescued by the fact that he had expended substantial time and effort in obtaining the parcel split, conferring sufficient benefit on the buyer to render the option irrevocable. Importantly, this benefit was found by the Court to be a benefit that the seller had bargained for when the contract was negotiated since there was evidence that he was willing to accept a lesser purchase price if the buyer performed the entitlement work. The Court did not definitively state what it would have held if the seller had changed his mind before Steiner had performed any work or expended any money on obtaining approvals or if the work that had been done was not something that the seller had bargained for during contract negotiations. In all likelihood, applying the Court’s reasoning, this would have resulted in the seller walking away without liability to the buyer.

Avoiding the results of the Steiner in the future will require a fact specific approach to negotiating and preparing the purchase agreement so that sufficient consideration is well documented. In all likelihood, however, we will continue to see the “irrevocable consideration” language in all future purchase contracts until the Court further clarifies the situation. If you have questions regarding this case, please contact Heather Johnston in our Real Estate Transactions Department.