January 1975

Contracts

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Recommended Citation
Lani Liu Ewart, Contracts, 63 Calif. L. Rev. 102 (1975).

Link to publisher version (DOI)
https://doi.org/10.15779/Z38NN05

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the traditional rational basis test, completely abandons the stricter standard of review and also fails to place any significant restraint upon the legislature. Both the Civil Code section 206 approach and the special benefits approach open the way for possible legislative abuse of the power to create statutory support obligations and to impose responsible relative provisions.

Alan M. Fenning

V

CONTRACTS

A. Broker's Right to Commission upon Withdrawal from Sale

Blank v. Borden.¹ The supreme court held that a real estate broker was entitled to recover a commission pursuant to an exclusive listing contract when the owner withdrew the property from the market in contravention of the brokerage agreement. The majority reasoned that the clause of the contract authorizing such a payment created an independent indebtedness upon occurrence of the withdrawal rather than a penalty, to be evaluated under the liquidated damages statutes,² for breach of the exclusive right-to-sell contract.³ The court refused to limit to quantum meruit the recovery of the discharged broker.⁴

Defendant Erica Borden entered into an exclusive right-to-sell contract with Ben Blank, a licensed real estate broker. She signed a printed form contract, drafted by the California Real Estate Association, which gave Blank the exclusive and irrevocable right for a seven month period to sell defendant's weekend home.⁵ The brokerage agreement provided that upon sale, the broker would be entitled to receive a com-

². Section 1670 of the Civil Code provides:

Every contract by which the amount of damage to be paid, or other compensation to be made, for breach of an obligation, is determined in anticipation thereof, is to that extent void, except as expressly provided in the next section.

CAL. CIV. CODE § 1670 (West 1974). Section 1671 defines and authorizes liquidation of damages, providing:

The parties to a contract may agree therein upon an amount which shall be presumed to be the amount of damage sustained by a breach thereof, when, from the nature of the case, it would be impracticable or extremely difficult to fix the actual damage.

CAL. CIV. CODE § 1671 (West 1974).
³. 11 Cal. 3d at 970-71, 524 P.2d at 130-31, 115 Cal. Rptr. at 33-34.
⁴. Id. at 973, 524 P.2d at 133, 115 Cal. Rptr. at 37.
⁵. Id. at 966, 524 P.2d at 128, 115 Cal. Rptr. at 32. The California Real Estate Association appeared as amicus curiae for plaintiff in the supreme court.
mission of 6 percent of the selling price. If the property were "withdrawn from sale, transferred, conveyed, leased without consent of Agent, or made unmarketable by [the owner's] voluntary act" while the contract was in force, the agent would be entitled to receive 6 percent of the listing price. Blank made a diligent effort to procure a purchaser for the property but had produced no prospective buyers. Two months after the contract was signed, while the listing was still in effect, Borden withdrew her home from the market "without reason or justification . . . in direct violation of said exclusive sales contract." The broker sued for the compensation provided by the terms of the agreement. The trial court awarded him $5,100 (6 percent of the $85,000 listing price) plus interest. The supreme court affirmed.10

During its last three terms the supreme court has decided three important contract damages cases—Garrett v. Coast & Southern Federal Savings & Loan Association,11 Fracasse v. Brent,12 and Blank. In the first two the court endeavored to protect individual consumers who contracted with parties of superior bargaining strength and skill, when the contract's contemplated performance went awry. In Blank the court validated case law which in some respects seems overly solicitous of the professional's interest in such nonperformance cases. Yet the three cases can be read together to articulate a coherent and consistent position.

Section I of this Note will examine the court's recent pronouncements in Garrett and Fracasse. Section II will analyze the majority's reading of the Blank withdrawal-from-sale provision; the minority's suggestion that the clause be evaluated as a provision for liquidated damages will be reviewed in section III. Section IV will discuss the implications of Blank and the pattern that emerges from the recent cases.

I. THE RECENT CASES

In Garrett,13 plaintiffs as obligors under promissory notes alleged
that charges imposed for late mortgage payments were penal\textsuperscript{14} and thus unenforceable since the charges were calculated as a fixed percentage of the remaining unpaid principal of their secured loans.\textsuperscript{15} Defendant responded that the late charges were not liquidated damages, subject to Civil Code sections 1670 and 1671.\textsuperscript{16} Instead, defendant characterized the loan agreement as giving the borrowers a choice of alternative performances of their obligations: If timely payments were tendered, interest would accrue at the contract rate; if such payments were not made when due, interest would be charged at a higher rate for the delinquency period.\textsuperscript{17}

In holding that plaintiffs had stated a cause of action, the court proffered a litmus test to distinguish liquidated damage situations from alternative performance options: Where the contract contemplates but a single, definite performance with an additional charge contingent only on the breach of that performance, liquidated damages are created, regardless of whether the contract expressly provides for alternative performances.\textsuperscript{18} Such clauses should be reasonably interpreted, with attention focused on the bargained-for performance, not the language used in the contract to describe it.\textsuperscript{19} In \textit{Garrett} the court found payment at the specified contract rate to be the bargained-for performance. Since additional sums were required only if the borrowers failed to adhere to their contractual duty to make timely payments, these amounts were liquidated damages for the "breach."\textsuperscript{20}

The court went on to hold the liquidated damage provision invalid as an attempt to coerce timely payment by a forfeiture not reasonably calculated to compensate the injured lender for his fair average loss.\textsuperscript{21} However, it acknowledged that the lender might be able to recover actual damages occasioned by the late payment, and that a lender could conceivably recover damages agreed to in advance by demonstrating the impracticability of prospectively fixing actual damages.\textsuperscript{22}

\textsuperscript{14} The court defined a penalty as a charge deemed void because it does not satisfy the test for liquidated damages specified in California Civil Code sections 1670 and 1671. 9 Cal. 3d at 736 n.4, 511 P.2d at 1200 n.4, 108 Cal. Rptr. at 848 n.4. Professor Sweet more pragmatically defines a penalty as "a clause designed to coerce performance rather than to estimate damages." Sweet, Liquidated Damages in California, 60 CALIF. L. REV. 84, 92 (1972).

\textsuperscript{15} 9 Cal. 3d at 740, 511 P.2d at 1203, 108 Cal. Rptr. at 851.

\textsuperscript{16} See note 2 supra.

\textsuperscript{17} \textit{Id.} at 736-37, 511 P.2d at 1200, 108 Cal. Rptr. at 848.

\textsuperscript{18} \textit{Id.} at 738, 511 P.2d at 1201, 108 Cal. Rptr. at 849.

\textsuperscript{19} \textit{Id.} at 737, 511 P.2d at 1200-01, 108 Cal. Rptr. at 848-49.

\textsuperscript{20} \textit{Id.} at 738, 511 P.2d at 1201, 108 Cal. Rptr. at 849.

\textsuperscript{21} \textit{Id.} at 740, 511 P.2d at 1202-03, 108 Cal. Rptr. at 850-51.

\textsuperscript{22} \textit{Id.} at 740-42, 511 P.2d at 1203-04, 108 Cal. Rptr. at 851-52. The court impliedly limits such a recovery, however, to instances in which the costs of ascertaining the actual damages may exceed the reasonable sum agreed to in advance by the parties as fair compensation. \textit{Id.} at 741-42, 511 P.2d at 1204, 108 Cal. Rptr. at 852.
Although *Fracasse v. Brent* was not a liquidated damage case, it was discussed at length in the *Blank* decision. *Fracasse* overruled cases allowing an attorney discharged by his client without cause to recover damages in the amount of the full fee specified in his contingent fee contract, regardless of the reasonable value of his services. The supreme court in *Fracasse* submitted the rule that an attorney discharged for any reason should be limited to *quantum meruit* recovery for the reasonable value of his services, upon the occurrence of any contingency contemplated by the contract, particularly any recovery by the client. The court's reasoning was bolstered by the relative ease with which the reasonable value of the attorney's services could be computed and by a public policy vesting in the client an absolute freedom to discharge his counsel at any time.

Neither *Garrett* nor *Fracasse* was expressly decided on the basis of adhesion contract theory. *Garrett* utilized a conventional contract and statutory analysis, and *Fracasse*, while discussing the public policy favoring absolute client choice, did not emphasize the obvious possibility of overreaching by the attorney. The two cases exemplify the phenomenon, commented upon by Professor Sweet, that in the area of liquidated contract damages courts proceed situation by situation, rather than in terms of formulating a coherent overall theory. Significantly, *Blank* viewed the *Garrett* and *Fracasse* situations as involving adhesionary dangers, and utilized this characterization to distinguish them from the brokerage contract before it.

II. THE COURT'S REASONING

The majority in *Blank* offered two theories to support full recovery for the broker. First, the action was for the recovery of a debt arising under the contract, and not for damages for its breach. Second, certain factual considerations militated against judicial interference in the contract agreed upon by the parties. The dissenters rejected both justifications; they would have applied a liquidated damages test to determine the broker's rights and would have characterized the specified damages provision as an ordinary penalty.
Adopting the teaching set forth in *Garrett*, the majority in *Blank* focused on whether, at the time the contract was made, it realistically contemplated a free choice between rational alternative performances or only a single performance with an additional charge contingent on breach of that performance. Applying this test, the court found that the exclusive right-to-sell contract gave this homeowner a realistic option; she could either let the broker sell her house and pay him a percentage of the selling price or withdraw her home from the market and pay him a percentage of the listing price. Thus the payment sought was a claim predicated on the contract itself—specifically, the clause in which the owner promised to pay should she withdraw. The court drew a fundamental distinction between "an action for breach of the promise by the owner not to revoke or deal through others or sell himself during the stipulated term, wherein damages are sought for such breach, and a contractual provision whereby, in consideration of the services of the broker to be and being rendered, the owner directly promises that if he sells through others or by himself or revokes he will pay a sum certain." Although some precedential support exists for the majority's in-

34. See note 17 *supra* and accompanying text.
35. 11 Cal. 3d at 970, 524 P.2d at 130-31, 115 Cal. Rptr. at 34-35.
36. There are three basic types of brokerage listings. The general listing is revocable at the will of the owner in good faith at any time before performance, regardless of the efforts expended by the broker. Such a listing leaves the owner free to list his property with other brokers, to sell it himself, or to withdraw it from the market. In the exclusive agency, terms are inserted in the listing which provide that for a stated period the owner will not deal through other brokers, but that he may sell the property himself without liability. Third, the exclusive right to sell agency precludes the owner himself from selling the property during the stated term without paying the brokerage commission. See *Tetrick v. Sloan*, 170 Cal. App. 2d 540, 546, 339 P.2d 613, 617 (2d Dist. 1959).
37. 11 Cal. 3d at 971, 524 P.2d at 131, 115 Cal. Rptr. at 35.
38. As the court of appeal expressed the distinction:
In view of the nature of the basic transaction between the owner and the broker, that is, a listing which is no more than an offer of a unilateral contract to be accepted only by a performance of the requested act, these additional stipulations were challenged in many courts as not resulting in any contract in fact between the parties [citations omitted]. But . . . in this state, courts have accepted such written listings as resulting in contractual relations. Though the basic offer to pay a commission for the procuring of a purchaser ready, able and willing to buy can still be accepted only by performance, nevertheless it has been held that these restrictive stipulations bind the owner and subject him to liability if he refuses to abide by them. These holdings are sometimes based on the idea that the restrictive clauses constitute subsidiary promises resting upon the consideration that the broker agrees to and does expend time and effort to bring about a sale.
39. *Id.* at 512, 272 P.2d at 556, quoted in *Blank v. Borden*, 11 Cal. 3d at 969, 524 P.2d at 130, 115 Cal. Rptr. at 34.
terpretation, such a reading is by no means compelled. In 1892, the court held in *Maze v. Gordon*\(^{41}\) that a broker’s action for a commission after the owner withdrew from an exclusive right-to-sell contract embodied a claim for a debt established by the terms of the contract rather than for damages due to its breach.\(^{42}\) The question in *Maze*, however, was whether the broker could recover *any* commission without having produced a ready buyer, and not the amount of recovery or the validity of a clause providing for such compensation.

The liquidated damage challenge was squarely presented for the first time in *Baumgartner v. Meek*.\(^{43}\) The court in *Blank* relied heavily on the refutation of the penalty theory in *Baumgartner*,\(^{44}\) despite inherent ambiguity in the latter’s interpretation of the case law. The court of appeal in *Baumgartner* grounded the broker’s recovery on decisions in which properties were not merely withdrawn from sale but were subsequently sold by the owners themselves.\(^{45}\) While some of these cases may be viewed as instances of independent indebtedness, they can be as well explained as damage actions for breach of exclusive right-to-sell contracts wherein the owner’s actual sale furnishes some evidence of the probability of a broker effecting a sale\(^{46}\) and the compensation to which he would be entitled had he sold the property,\(^{47}\) thereby determining the extent of the broker’s recovery. In fact, the two explanations have been used interchangeably to explain the same result.\(^{48}\)

When there is no sale by the owner, as in *Blank*, two different considerations arise. First, if the property is not sold, there is no functional equivalence between the independent debt and the damages for breach theories so far as the outcome—recovery vel non for the broker—is concerned. If the action is for breach of contract, the broker will be precluded from recovery in the absence of a showing by a preponderance of the evidence that he could have sold the property.\(^{49}\)

\(^{41}\) 96 Cal. 61, 30 P. 962 (1892).

\(^{42}\) *Id.* at 66-67, 30 P. at 963.


\(^{44}\) 11 Cal. 3d at 969-70, 524 P.2d at 130, 115 Cal. Rptr. at 34.


\(^{48}\) *See, e.g.*, Walter v. Libby, 72 Cal. App. 2d 138, 142, 164 P.2d 21, 23 (3d Dist. 1945).

\(^{49}\) *Id.* at 478-79, 81 Cal. Rptr. at 172-73.
Second, it may be realistic to assume that a homeowner who is willing to sell property through a broker for $100,000, grossing $94,000 after paying the 6 percent commission, will also be satisfied to sell it himself for $100,000, still grossing $94,000 after paying the broker $6,000 under the commission-upon-withdrawal clause of the contract; that is, either of the "alternative performances" are foreseeable. It is not so realistic to assume, as does the court in Blank, that the owner would be equally willing to keep his house and be out of pocket $6,000 under the contract.50

These problems illustrate the weakness of the alternative performance analysis adopted in Blank. Professor Sweet has noted that the alternative performance "device has been . . . used by courts to enforce clauses that they believed they could not enforce as liquidation of damages provisions" but which they believed to be reasonable remedies.51 That the majority articulated "[f]urther considerations"52 supporting the broker's recovery suggests that the alternative performance doctrine was equally a device which allowed the court to reach the result it considered proper.

In addition to its alternative performance analysis, the court articulated three factors to support the broker's recovery of a full commission. First, it noted that the brokerage contract was "freely negotiated by parties dealing at arm's length."53 Thus interference with the parties' contract was "less justified" than if the brokerage agreement were the product of an adhesion relationship.54 The court bolstered this logic by observing that property owners have considerable choice in determining contract relations with their brokers.55 Had the owner here entered into an exclusive agency or open listing, she could have sold or withdrawn with impunity. Instead, she chose an arrangement which entitled her to the broker's strongest efforts, and then balked at paying the price she had promised.

This characterization of the homeowner's available options may not be entirely accurate. To the extent that a homeowner needs a broker's best efforts, the owner may have no choice but to agree to a commission-upon-withdrawal clause, since such language appears in the

50. The dissent in Blank found it "wholly naive to assume, as the majority do, that a property owner would have bargained for the 'option' of withdrawing the property from sale, given the consequences of exercising that option, namely, the payment of the full commission which would have been payable to the broker had he sold the property for the original $85,000 asking price." 11 Cal. 3d at 975, 524 P.2d at 134, 115 Cal. Rptr. at 38 (emphasis in original). See also Sweet, supra note 14, at 111 n.127.
51. Sweet, supra note 14, at 141.
52. 11 Cal. 3d at 972, 524 P.2d at 132, 115 Cal. Rptr. at 36.
53. Id.
54. Id.
55. Id. n.8. See note 36 supra.
standard California exclusive right-to-sell contract. Moreover, whether the owner in fact knows that other contract arrangements are available is a question left unexplored in Blank, despite the court's talk of arm's-length bargaining. Some courts have found that the dangers lurking in the real estate brokerage situation can approximate those in other consumer-professional situations which are often characterized as adhesionary.

The court pointed to the result-oriented nature of the brokerage contract as a second consideration supporting full recovery by the broker. Normally the broker recovers only if he makes a sale, no matter how great his efforts and expense. Thus upon an owner's wrongful withdrawal, the measure of damages for breach, were that analysis adopted, would be the value of the broker's lost opportunity to earn a commission. Recognizing the difficulty of measuring the loss, the court observed that such a determination "would clearly degenerate into an examination of fictional probabilities . . . ."

Ironically, this reasoning could have supported recovery for the broker under a liquidated damages theory. Essentially the court found as a matter of law that part of the statutory test for upholding agreed damages was satisfied, that is, that fixing of actual damages for breach was impracticable or extremely difficult at the time the contract was made.

The court finally observed that since policies relevant in the attorney-client relation are not present in the broker-homeowner relation, the Fracasse limitation to quantum meruit recovery after breach would be inapposite. The court gave three reasons for maintaining this distinction. First, the contingent fee contract lacked the alternative performance language found in the brokerage contract. Second, the attorney's bargaining position is vastly superior to that of his client. Third, there is a special value in allowing a client to freely discharge his attor-

56. 11 Cal. 3d at 975, 524 P.2d at 134, 115 Cal. Rptr. at 38 (dissenting opinion). Amicus in the Blank case argued that the owner's promise to pay an agreed sum upon withdrawal was consideration for the broker's promise to exert his best possible efforts to sell the property. Brief for California Real Estate Association as Amicus Curiae at 6.

57. See text accompanying note 53 supra. See also 1 H. MILLER & M. STARR, CURRENT LAW OF CALIFORNIA REAL ESTATE 212-19 (1965).


59. 11 Cal. 3d at 972, 524 P.2d at 132, 115 Cal. Rptr. at 36.

60. Id. at 972-73, 524 P.2d at 132, 115 Cal. Rptr. at 36.

61. See note 2 supra.

62. Id.
ney without incurring liability for the latter's expectancy damages, a public policy not present in the brokerage contract setting.\(^6\)

Integral to these arguments was the majority's determination that the situation before it was not adhesionary. Once this basic characterization was adopted, Garrett and Fracasse could be readily distinguished and full recovery for the broker upheld.

III. THE MINORITY POSITION: LIQUIDATED DAMAGES

The dissenters in Blank countered the majority's alternative performance and independent indebtedness rationales by highlighting California decisional law in which courts had voided commission-upon-withdrawal clauses drafted in terms of liquidated damages for contractual breach.\(^6\)\(^4\) Moreover, the minority persuasively argued, in an opinion written by Justice Burke and joined by Justice Tobriner, only one performance was actually bargained for\(^6\)\(^6\) so that the commission-upon-withdrawal clause "was intended to compensate the broker for damages arising from the owner's breach of the exclusive brokerage contract."\(^6\)\(^6\) Under this analysis, the clause would have been evaluated in terms of the statutory language regulating provisions for liquidated damages.\(^6\)\(^7\)

Section 1671 of the Civil Code authorizes liquidated damages only in cases where "it would be impracticable or extremely difficult to fix the actual damage."\(^6\)\(^8\) The case law has added a second test that a provision for agreed damages must satisfy. It must be demonstrated that the parties at the time of contracting made a reasonable effort to fix the fair average compensation for the breach.\(^6\)\(^9\)

As has been noted,\(^6\)\(^0\) the majority commented upon the difficulty of determining actual damages in language implying that the requirements of section 1671 were satisfied. Had a liquidated damages analysis been adopted, however, it would be difficult to argue that the Blank clause passed the second case law test. By agreeing to give the broker a commission upon withdrawal based on the property's listing price, the parties had contracted for greater than average compensation.

\(^{63}\) Id. at 972, 524 P.2d at 132, 115 Cal. Rptr. at 36.
\(^{65}\) 11 Cal. 3d at 974, 524 P.2d at 133-34, 115 Cal. Rptr. at 37-38 (dissenting opinion).
\(^{66}\) Id. at 977, 524 P.2d at 136, 115 Cal. Rptr. at 41 (dissenting opinion).
\(^{67}\) See note 2 supra.
\(^{68}\) CAL. CIV. CODE § 1671 (West 1974). The full language is set out at note 2 supra.
\(^{70}\) See text accompanying note 61.
Not all listed properties will sell, and of those that do many will not sell at the listing price.\textsuperscript{71} Moreover, it could be expected that if the owner wrongfully withdrew his property the broker would be able to save some of the expense which would be generated by an extended selling effort. To meet the reasonable efforts requirement of the cases, a commission-upon-withdrawal clause would have to require payment of a sum that took into account the realities of the exclusive listing sales picture.\textsuperscript{72}

The cases referred to by the minority\textsuperscript{73} did not utilize this average compensation analysis. Instead, they characterized withdrawal provisions as liquidated damages clauses and voided stipulated amounts bearing no relation to the commission that would have been paid had a sale been effected. In fact, there is dictum that such an amount \textit{would} have provided a proper measure of the broker's recovery.\textsuperscript{74}

Another approach utilizing liquidated damages theory to uphold a modified recovery for the broker would allow compensation in an amount equal to a commission based on the market price of the property at the time of withdrawal from sale (if this were lower than the listing price), less expenses mitigated by reason of the breach.\textsuperscript{75} This analysis would have avoided the manifest overcompensation of the broker upheld in \textit{Blank}. It would also have clarified liquidated damages law, which the alternative performance theory fails to do.

\textbf{IV. IMPLICATIONS OF THE DECISION}

\textit{Blank} reaffirmed the validity of the familiar commission-upon-withdrawal provision in the exclusive right-to-sell contracts. Homeowners who sign such contracts and then withdraw their properties from sale before the termination date will be liable for the full broker's commission. The impact of \textit{Blank} on contracts other than real estate brokerage agreements is unclear. Professor Sweet has noted the court's

\textsuperscript{71} 11 Cal. 3d at 978-79, 524 P.2d at 136-37, 115 Cal. Rptr. at 40-41 (dissenting opinion).

\textsuperscript{72} Assuming, for example, that one in every ten houses listed with brokers under exclusive listing contracts does not sell during the listing period, and that the remaining nine are sold for an average price of 90 percent of the listing price, it would seem that a commission-upon-withdrawal clause could require payment of approximately 80 percent of the regular commission on the listing price. If these were the facts available to the drafters of an exclusive listing contract, and if the commission on sale were six percent, then a commission-upon-withdrawal clause could provide for a payment of 4.8 percent of the listing price and presumably meet the reasonable efforts requirement. An additional downward adjustment would have to be made to provide for the selling expenses saved by the broker due to the contract's termination.

\textsuperscript{73} See note 64 supra.

\textsuperscript{74} McInerney v. Mack, 34 Cal. App. 153, 157, 166 P. 867, 868-69 (1st Dist. 1917).

\textsuperscript{75} See note 72 supra.
tendency to analyze separately each type of contract,\textsuperscript{76} and certainly \textit{Blank}'s cursory treatment of recent precedent in different subject areas encourages this diversified approach.\textsuperscript{77}

On the other hand, the court's finding that the \textit{Blank} agreement was devoid of adhesionary features, contrasted with its perception of such dangers in \textit{Garrett} and \textit{Fracasse}, may indicate that adhesion vel non is the crucial determination. Liquidated damages provisions are more likely to be found and held penal in adhesion contracts, while other clauses may be characterized as alternative performance options where the court wants to defer to party autonomy.

The alternative performance analysis of \textit{Blank} should not be extended to situations in which adhesionary dangers are shown to be present. Nor should courts uphold thinly-disguised penalty clauses when there is clearly only one bargained-for performance. In \textit{Blank} the majority had to strain to find that the homeowner had a "realistic and rational" option of alternative performance.\textsuperscript{78} The commission-upon-withdrawal clause upheld in \textit{Blank} should represent the furthest extension of alternative performance analysis rather than an exemplar for the elevation of form over substance. Only then can the strong consumer-protection approach taken by the court in \textit{Garrett} and \textit{Fracasse} be reconciled with the deference paid to party autonomy in \textit{Blank}.

\textit{Joanne B. Grossman}

\textbf{B. Exercise of Option Effective on Mailing}

\textit{Palo Alto Town \& Country Village, Inc. v. BBTC Co.}\textsuperscript{1} In an action for declaratory relief to determine when notice of the exercise of an option is effective, the California Supreme Court adopted the rule that notice of the exercise of an option takes effect on its deposit in the ordinary mail. The court held that Civil Code section 1583, relating to when the acceptance of a proposal is deemed communicated, applies to irrevocable options as well as to revocable offers, despite the apparent inapplicability of that section in the option context. In so holding, the court rejected the majority rule that an option is effectively exercised only when notice of its exercise is actually received by the optionor.

\textsuperscript{76} See Sweet, supra note 14, at 92.
\textsuperscript{77} 11 Cal. 3d at 972-73, 524 P.2d at 132-33, 115 Cal. Rptr. at 36-37.
\textsuperscript{78} \textit{Id.} at 972, 524 P.2d at 132, 115 Cal. Rptr. at 36.

\textsuperscript{1} 11 Cal. 3d 494, 521 P.2d 1097, 113 Cal. Rptr. 705 (1974) (Sullivan, J.) (unanimous decision).
I. FACTS OF THE CASE

Pursuant to a five-year lease, defendant BBTC leased from plaintiff Town & Country certain improved real property for the operation of a restaurant and bar in a large shopping center. The lease granted defendant the right to extend this initial term for two five-year periods through the exercise of two successive options. In order to exercise the options, the defendant-lessee was required to give the plaintiff-lessor written notice not less than six months prior to the expiration of the current term.

On June 5, 1969, more than six months prior to expiration of the initial term, defendant's attorney prepared and signed an unconditional exercise of the first five-year option, and deposited it in the mail in a stamped envelope addressed to plaintiff. BBTC thereafter continued to operate the restaurant, making substantial long-term capital improvements, as well as various expenditures for services, in contemplation of an additional five-year term. On February 13, 1970, approximately one and one-half months into the first extended five-year term and eight and one-half months after the mailing of the notice exercising the option, the lessor notified BBTC that the lease had expired for want of renewal and demanded surrender of the premises by March 31, 1970. The lessor claimed that no notice exercising the option had been received. BBTC refused to vacate; instead it continued its usual operations and periodically tendered the rent required for the first extended five-year term, contending that it had properly exercised the option.

Plaintiff-lessor instituted an action for declaratory relief regarding the rights and obligations of the parties under the lease. In its answer, BBTC alleged proper exercise of its option extending the term of the lease and further contended that its continued operations on the premises were such that the lessor knew or should have known that the lessee intended to extend its tenancy. The trial court entered a judgment declaring that the option had been properly exercised and that BBTC was rightfully in possession of the premises. This judgment was affirmed by the court of appeal.

2. Defendant-lessee also filed a cross-complaint in which it sought damages for plaintiff's allegedly wrongful action in threatening defendant's peaceful possession and plaintiff's alleged interference with defendant's remodeling plans and negotiations for the sale of its business. Id. at 498, 521 P.2d at 1098, 113 Cal. Rptr. at 706.

3. The court also ordered that plaintiff recover from defendant additional rental in the sum of $4,000, but made no mention of defendant's cross-complaint for damages. Defendant apparently abandoned its damage claim on appeal. Id. at 498 n.2, 521 P.2d at 1098 n.2, 113 Cal. Rptr. at 705 n.2.

Before the supreme court, the lessor contended that the option had not been effectively exercised because the mode of acceptance used by the optionee did not conform to the manner prescribed by the lease. The lessor further contended that, even if the mode of acceptance were proper, the "effective on mailing" rule of section 1583 is inapplicable to option contracts, and that the attempted exercise of the option was of no effect since not timely received by the optionor under the terms of the option contract.

II. MODE OF ACCEPTANCE

The lessor's first contention was that the tenant had not exercised the option through a reasonable and usual mode of communication as required by Civil Code section 1582. Essentially the argument was that, in a transaction of such commercial significance, the exercise of the option through the ordinary mail was not a reasonable and usual mode of acceptance. The court justifiably dismissed this contention by pointing not only to the common acceptance of ordinary mail in commercial transactions, but also to the agreement and conduct of the parties in the present dispute. In light of the acknowledgment of ordinary mail as a reasonable vehicle of communication in paragraph 19 of the lease, and the use of ordinary mail as the established mode of correspondence between the parties during the initial five-year term of the lease, the use of the mail to exercise the option was reasonable.

The lessor's second argument was that the option had not been effectively exercised since, by the terms of paragraph 45 of the lease which provided for exercise of the option by "giving notice," the parties had agreed that actual receipt of notice by the lessor was to be a condition of effective exercise. Relying on a single California precedent, Estate of Crossman, the court rejected this contention. It ignored or dismissed out of hand authorities from other jurisdictions.

5. 11 Cal. 3d at 500, 521 P.2d at 1100, 113 Cal. Rptr. at 708.
6. Id.
7. Paragraph 19 of the lease provided:
   All notices to be given to Lessee may be given in writing personally or by de-
   positing the same in the United States mail, postage prepaid, and addressed to
   Lessee at said premises, whether or not Lessee has departed from, abandoned
   or vacated the premises.
11 Cal. 3d at 499 n.5, 521 P.2d at 1099 n.5, 113 Cal. Rptr. at 707 n.5.
8. See Palo Alto Town & Country Village, Inc. v. BBTC Co., 110 Cal. Rptr. 93,
9. Paragraph 45 of the lease provided: "Lessee may, by giving not less than six
   months prior notice in writing to the Lessor, extend this lease for an additional five
   years." 11 Cal. 3d at 497, 521 P.2d at 1098, 113 Cal. Rptr. at 706 (emphasis added).
11. 11 Cal. 3d at 499, 521 P.2d at 1099, 113 Cal. Rptr. at 707.
12. See, e.g., Scott-Burr Stores Corp. v. Wilcox, 194 F.2d 989, 990-91 (5th Cir.
interpreting “giving notice” as requiring actual receipt.\textsuperscript{13}

The hasty rejection of the “receipt” interpretation of “giving notice” is not justified by the facts of Estate of Crossman, and the court’s reliance upon that decision as a talisman of contractual construction was not warranted. While Crossman did equate “giving notice” with sending notice rather than with receipt,\textsuperscript{14} this result was reached through an interpretation of the parties’ particularized usage of the word “giving” in the contract. In Crossman the terms of the option contract required any notice by either party, including the optionee’s notice exercising the option, to be “given in writing, either delivered personally or \emph{sent} by prepaid registered mail.”\textsuperscript{15} Thus the parties themselves had used the words “given” and “sent” synonymously. Moreover, the contract in Crossman specifically provided that notice given by mail “shall be deemed to have been consummated upon the expiration of twenty-four (24) hours from the time of deposit thereof in any United States depositary for mail.”\textsuperscript{16} Thus the court concluded that the exercise of the option was effective either upon its posting or 24 hours after that time under the contract provision. Finally, the importance to be attached to the court’s construction of the term “giving notice” was minimized in Crossman by the fact that the optionor waived any objection to the mode of communicating the notice by acknowledging exercise of the option.\textsuperscript{17}

In addition to relying on Crossman, the court noted that paragraph 19 of the BBTC lease,\textsuperscript{18} regarding notices from the lessor to the lessee, could be read as equating “giving notice” with sending notice. Apparently invoking the principle of contractual construction that words used in a certain sense in one part of an instrument are deemed to have been used in that same sense elsewhere in the instrument,\textsuperscript{19} the court dismissed without further discussion the lessor’s contention that the term “giving notice,” as it was used in paragraph 45, required actual receipt of the lessee’s notice by the lessor.

Paragraph 19 applied only to notices to the lessee. Arguably, if the parties had intended to include within that provision notices to the lessor, as the court implied that they did, they would have so pro-

\begin{itemize}
  \item \textsuperscript{13} 11 Cal. 3d at 498 n.3, 521 P.2d at 1099 n.3, 113 Cal. Rptr. at 707 n.3.
  \item \textsuperscript{14} 231 Cal. App. 2d at 373, 41 Cal. Rptr. at 802.
  \item \textsuperscript{15} \textit{id.} at 371, 41 Cal. Rptr. at 800-01 (emphasis added).
  \item \textsuperscript{16} \textit{id.}, 41 Cal. Rptr. at 801.
  \item \textsuperscript{17} \textit{id.} at 372, 41 Cal. Rptr. at 801.
  \item \textsuperscript{18} See note 7 supra.
\end{itemize}
vided. However, the purpose of paragraph 19, as evidenced by the reference to the lessee's departure from or abandonment of the premises, was to supply a procedure whereby legal notices to pay rent, to abate nuisances, to surrender possession, or to acknowledge abandonment of the premises might be "given" to a tenant who could not be found, either because he had vacated the premises, was otherwise absent, or was avoiding service of such notices. Since a defaulting tenant might be very difficult to locate the provision afforded an equitable means of serving notice on the lessee where it would be otherwise impossible to assure physical receipt.

These same considerations generally do not apply to landlords. Typically landlords are not in default, can be found for purposes of serving notice, and do not intentionally absent themselves to avoid such service.

Despite the reliance in Palo Alto on the Crossman construction term "giving notice" and the usage of that term in paragraph 19 of the lease, the conclusion is not compelled that for notice to be "given," it need only be deposited in the mail. In the absence of more persuasive reasons for rejecting the position adopted by most of the jurisdictions which have considered the issue, the court should have followed the rule that the term "giving notice" requires actual receipt by the optionor.

III. APPLICATION OF SECTION 1583

Having concluded that the option contract itself did not require that a notice exercising the option be received by the lessor, the court proceeded to determine whether section 1583 should be applied to make the notice of exercise effective upon posting.

Where the formation of a bilateral contract is under consideration, it is the majority rule that an acceptance of a revocable offer is effective and deemed communicated to the offeror upon deposit in the regular course of the mail, whether or not it is actually received.

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20. The trial transcript reflects that the lease agreement was the result of extensive negotiations between the parties (Record at 37), implying the ability of the parties, if they so desired, to provide that notices to the lessor would be governed by the terms of paragraph 19.

21. This is especially true when the landlord is the management of a large shopping center, as in Palo Alto. Such a landlord must be readily available to tenants to avoid deterioration of the business.

22. E.g., State v. Agostini, 139 Cal. App. 2d 909, 915, 294 P.2d 769, 773 (1st Dist. 1956); Ivey v. Kern County Land Co., 115 Cal. 196, 200-01, 46 P. 926, 927 (1896); accord, 1 A. CORBIN, CORBIN ON CONTRACTS § 78 (1963) [hereinafter cited as CORBIN ON CONTRACTS]. This is substantially the holding of Adams v. Lindell, 106 Eng. Rep. 250 (K.B. 1818), the English case which propounded the so-called "mailbox rule."
This substantive "effective upon mailing" rule has been codified in California in Civil Code section 1583, which states that consent is deemed to be fully communicated between contracting parties as soon as the party accepting a "proposal" has put his acceptance in the course of transmission to the proposer.23

The propriety of including irrevocable options as well as revocable offers within the scope of section 1583 was presented squarely for the first time in Palo Alto.24 Drawing heavily on dicta in earlier option cases, the court posited that an option contract is a "proposal" and that its exercise is an "acceptance" within the meaning of section 1583.25 Thus section 1583 was held to be applicable both to the acceptance of revocable offers in bilateral contracts and to the exercise of irrevocable options in option contacts.26 In so doing, the court rejected the majority rule,27 and the rule accepted by the Second Restatement of Contracts that "[a]n acceptance under an option contract is not operative until received by the offeror."28

a. Prior California decisions

Although the California Supreme Court had never held that an option contract is a proposal within the meaning section 1583, the court cited dicta in one of its own decisions and earlier court of appeal cases in support of this proposition.29 The cases relied upon, however, lend little or no support to the court's assertion that an option is effectively exercised in California when written acceptance is deposited in the mail.

In Dawson v. Goff,30 the only prior California Supreme Court decision discussing the question, the court stated in dictum that section

23. When communication deemed complete. Consent is deemed to be fully communicated between the parties as soon as the party accepting a proposal has put his acceptance in the course of transmission to the proposer, in conformity to the last section. Cal. Civ. Code § 1583 (West 1974).

24. Id. at 501, 521 P.2d at 1100, 113 Cal. Rptr. at 708.

25. Id. at 504, 521 P.2d at 1102-03, 113 Cal. Rptr. at 710-11.

26. Id. at 501, 521 P.2d at 1101, 113 Cal. Rptr. at 709.


1583 is applicable to option contracts. In that case, plaintiff and defendant entered into a contract in San Diego County under which plaintiff had the option of requiring defendant to purchase certain stock. Plaintiff mailed notice exercising the option in Los Angeles County, and then sued for damages resulting from defendant's refusal to perform by purchasing the stock. Plaintiff filed suit in Los Angeles County but, on the motion of defendant, venue was changed to San Diego County. In affirming the order transferring the action, the court found that, for purposes of determining the obligations of the optionor, the contract was made and the defendant bound when the option contract was executed, in San Diego County, rather than when notice of exercise of the option was mailed in Los Angeles County. Because the defendant was bound from the moment the option was executed, for venue purposes the contract was formed at that time, irrespective of where and when the option was subsequently exercised. Since the venue determination focused on the contractual duty of the optionor, the court's cursory consideration of the "effective on posting" rule to determine the time at which the optionee became bound was irrelevant and unnecessary.

As authority for the applicability of the "effective upon posting" rule to the exercise of an option, both Dawson and Palo Alto cited Canty v. Brown. That case is not controlling, however, since the optionee's telegraphic acceptance was neither timely sent nor received, making consideration of the applicability of the "posting" rule unnecessary to the court's decision. Conversely, in State v. Agostini, notice exercising the option was timely under either the "posting" or "receipt" standard, again making an analysis of the "effective upon posting" rule unnecessary.

31. Id. at 316, 273 P.2d at 4.
32. Id. at 318, 273 P.2d at 5. At the time of the decision in Dawson, Code of Civil Procedure section 395 regarding venue provided:

In all other cases, except as in this section otherwise provided, and subject to the power of the court to transfer actions or proceedings as provided in this title, the county in which the defendants, or some of them, reside at the commencement of the action, is the proper county for the trial of the action. . . . When a defendant has contracted to perform an obligation in a particular county, either the county where such obligation is to be performed, or in which the contract in fact was entered into, or the county in which the defendant, or any such defendant, resides at the commencement of the action, shall be a proper county for the trial of an action founded on such obligation, and the county in which such obligation is incurred shall be deemed to be the county in which it is to be performed unless there is a special contract in writing to the contrary.

34. Id. at 491, 105 P. at 430.
36. Id. at 911, 294 P.2d at 770-71. Curiously, although Agostini clearly involved
Also cited in Palo Alto for its precedential support of the "posting" rule in Estate of Crossman. In Crossman, a timely sent notice by the optionee exercising the option was not received by the optionor within the specified period. The optionor promptly wrote the optionee and acknowledged proper exercise of the option. Subsequently, the optionee sought to disaffirm his own exercise of the option. Rejecting this attempt, the court applied without discussion the "effective upon mailing" rule of section 1583. At the same time, however, the court implied that application of section 1583 was unnecessary since the terms of the contract provided that acceptance was to be deemed consummated twenty-four hours after deposit, and the notice had been posted some twenty-nine hours before expiration of the period granted for exercise.

Finally, Morello v. Growers Grape Products Association involved the effectiveness of an acceptance exercised under a right of first refusal. Although there is some conceptual similarity between such a right and an option, the court treated the right of first refusal as an ordinary offer to enter into a bilateral agreement and not as an option. The "effective on posting" rule was then correctly applied since acceptance of a simple offer as a prelude to a bilateral contract is clearly within the purview of that statute.

A critical examination of the above California decisional law reveals that the question of the applicability of section 1583 to an option contract was not squarely present to a California court until the issue arose in Palo Alto. Instead of attributing controlling weight to the dicta of these earlier cases, the court should have dealt with the issue free of any restraint of stare decisis.

b. The nature of the option transaction

As noted earlier, section 1583 provides that a contract is formed as soon as the party "accepting a proposal" has put his acceptance in the course of transmission to the proposer.

Since there is little or no controlling authority in prior California decisions to either require or prevent the application of section 1583 to the exercise of an option, its applicability can be determined only after inquiring whether the option transaction reasonably can be said to fit within the language of the statute. Necessary to this determination is an understanding of the nature of the option transaction.

an option contract, the court dealt with the acceptance in the context of a bilateral contract only, id. at 915, 294 P.2d at 773, and considered the point without citing Dawson.

38. Id. at 374, 41 Cal. Rptr. at 802.
40. Id. at 370-71, 186 P.2d at 467.
The option transaction is actually an intricate combination of two contracts. The first, called the "option contract" for purposes of this discussion, involves the formation of a unilateral contract wherein the optionor agrees to bind himself to perform some act in the future, subject only to the condition precedent of exercise of the option by the optionee. The second contract, formed at the time the option is exercised, is a simple bilateral contract. Both parties become bound to perform some act or give some consideration, and the obligation of each is enforceable by the other. Thus the option transaction can be viewed conceptually either as "a unilateral contract which binds the optionor to perform an underlying agreement upon the optionee's performance of a condition precedent,"\textsuperscript{41} or as "an irrevocable offer which upon acceptance ripens into a bilateral contract."\textsuperscript{42}

The plaintiff in \textit{Palo Alto} contended that the dual nature of the option cannot be subsumed compatibly under the aegis of the statute. Arguably, the only "proposal" within the literal terms of the statute is the opening offer of either party to enter into an option contract. The "effective on mailing" rule of the statute clearly should apply to the optionee's acceptance of this proposal. Once the option contract has been created, however, there is no further "proposal" by the optionor but only his continuing obligation to perform in accordance with the underlying agreement. This obligation cannot be fairly categorized in the same legal niche as a "proposal" within the purview of the statute. The optionee's exercise is not a contractual "acceptance," but only the removal of a condition precedent through a demand that the optionor render the promised performance. The optionee's election is analogous to the demand of an obligee in a requirements contract that the obligor comply with the promised course of conduct. Since there is no "proposal" in the optionor's inchoate duty to perform, section 1583 and the "effective on posting" rule become inapposite.

Confronted with the plaintiff's argument that the exercise of an option does not fit within the language of the statute, the court contended that under one conception of the option transaction, the optionee's exercise of the option was the "acceptance" of an irrevocable "offer." The court stated that section 1583 was applicable because that provision focused upon the optionee's act in exercising the option, and, from the viewpoint of the optionee, to exercise the option was actually to "accept" the irrevocable "offer" of the optionor.\textsuperscript{43}

There are a number of weaknesses in the court's analysis. First, it is unlikely that the term "proposal" as it is used in section 1583 in-

\textsuperscript{41} 11 Cal. 3d at 502, 521 P.2d at 1101, 113 Cal. Rptr. at 709.

\textsuperscript{42} \textit{Id.}

\textsuperscript{43} \textit{Id.} at 503, 521 P.2d at 1102, 113 Cal. Rptr. at 710.
cludes irrevocable offers since Civil Code section 1586 states that "[a] proposal may be revoked at any time before its acceptance is communicated to the proposer." 44

Second, characterizing the option transaction from the optionor's viewpoint as a unilateral contract which becomes binding upon the optionee's performance of a condition precedent, but characterizing it from the optionee's viewpoint as an irrevocable offer to which section 1583 applies is analytically unsound. The major fault in this approach is its inability to dictate which of the two perspectives should be applied to a given transaction. In explaining how it has made similar choices in the past, the court stated:

Where the issue presented in a case focused upon the optionor's obligation, the former analysis [the option is a binding contract subject to the performance of a condition precedent by the optionee] prevailed, so that in Dawson it was held that, as to the optionor, the contract was made upon the signing of the option contract and therefore venue in a suit to enforce the option lay where the option contract was made and not where the option was exercised. However, where the issue focused upon the optionee's action the latter analysis [the option is an irrevocable offer] prevailed, as in [Estate of] Crossman where the court held that acceptance of an option was effective upon posting pursuant to section 1583. 45

While the reasonableness of choosing the perspective of one party or the other may be apparent in a case like Dawson, this determination becomes increasingly arbitrary in the more complex contexts presented in cases such as Crossman and Palo Alto. At issue in Dawson v. Goff was the point at which the obligor incurred a binding contractual obligation. Since the optionor and optionee obligated themselves at temporally separated points, an atomistic analysis of their rights and duties was a logical approach. In Palo Alto and in Crossman, on the other hand, the crucial event, exercise of the option, imposed obligations on both parties at the same moment in time. Whether that event should be viewed as the performance of a condition precedent or as the acceptance of an irrevocable offer is not clear. The court in Palo Alto chose to ignore the expectation of the optionor that his obligation was terminated when the condition precedent was not performed within the specified time limit. Instead the court declared that the issue was not the optionor's obligation but rather that the issue was one of the optionee's actions in attempting to exercise the option. Hence the option transaction should be viewed as an irrevocable offer to which section 1583 applied. 46 There is nothing in the

44. CAL. CIV. CODE § 1586 (West 1974).
45. 11 Cal. 3d at 503-04, 521 P.2d at 1102, 113 Cal. Rptr. at 710.
46. Id.
nature of the exercise of the option or in court's analysis of the exercise of the option which dictates the latter characterization rather than the former and the court's language must be deemed conclusory, at best.

c. Commercial reality

The degree to which the "perspective of the parties" rationale parallels commercial reality is also dubious. The court offers no reasoned analysis demonstrating that the parties themselves partake of this schizophrenic approach to their respective rights and duties. Indeed the intention of the parties is likely to reflect only the condition precedent model. The parties have agreed, for a bargained-for consideration to the optionor, that the period in which the option can be exercised shall extend until a certain date. The parties must implicitly recognize that after the termination of the option period the optionor will no longer be under any obligation to the optionee and may instead negotiate an alternative agreement with a third party. Absent an express provision prescribing a later permissible time of acceptance, the optionee is likely to exercise the option early enough to bring the notice of acceptance to the attention of the optionor prior to the expiration of the option period, rather than to wait until the last day of the period before exercising the option. However, it is this latter course of conduct which Palo Alto approves.

Adherence to the rule of Palo Alto essentially allows a court to reform the contract negotiated between the parties. The optionor becomes obligated to postpone the creation of a legal relationship with a third party until a date subsequent to the expiration of the option, to allow for transit in the mail of an acceptance which may in fact not be forthcoming. Palo Alto leaves unexplained the rationale for imposing this additional duty upon the optionor and would appear contrary to the actual expectations of the parties at the time the contract was formed. Its effect is to undermine the predictability which is essential to commercial transactions. In its choice of an atomistic and unpredictable "perspective of the parties" rule, the court failed to seize the opportunity to set forth an integrated approach which would more adequately serve the needs and effectuate the intentions of the contracting parties.

IV. EQUI TABLE RELIEF FROM THE DEPOSIT RULE

The rigidity of the "effective upon mailing" holding of Palo Alto precludes any consideration of equitable factors in individual instances. Where the optionee's notice is timely dispatched, the optionor is bound where he does not receive the notice until after the period for exer-
exercise of the option, or where the notice miscarries in the mail. The inflexibility of the “mailing” rule provides no protection to the optionor who contracts with a third party in reliance on the optionee’s apparent failure to exercise the option. Conversely, to condition effectiveness of acceptance on actual receipt by the optionor makes the optionee vulnerable where his communication is delayed or lost through no fault of his own. Since it is usually within the optionor’s power to include in the contract a stipulation making notice effective only upon receipt, judicial or statutory allocation of the burden of inadvertent delay or loss to the optionee seems especially inequitable. Under either the “mailing” or “receipt” rule the possibility that one party’s innocent and detrimental reliance will go unprotected seems unavoidable.

A judicially manageable rule of law which allows a response to the equities in particular factual situations is suggested in a recent case factually similar to *Palo Alto*. In *Holiday Inns of America, Inc. v. Knight*\(^47\) the plaintiff-optionee executed an option contract with the defendant-optionor to purchase certain real property. The contract provided for a five-year period in which the option could be exercised, with periodic payment to be made annually unless the option was exercised or cancelled. It was agreed that failure to make timely payment would automatically cancel the option. Timely annual payments were made for three years and during that interval the optionee spent considerable sums improving the real property adjacent to the option property. The fourth annual payment was mailed the day before the expiration date for exercise of the option but not received by the optionor until after the period to renew the option had expired. Although the optionee argued for the same “effective on posting” rule subsequently validated in *Palo Alto*,\(^48\) the California Supreme Court held that if the option contract were terminated by an untimely tendered payment, the optionee would suffer a loss in the nature of a forfeiture, which would be prohibited under Civil Code section 3275.\(^49\)

As the court saw it, the problem was not whether the exercise of the option was timely, but whether failure to exercise the option on time would cause a forfeiture of the right to exercise the option in the

\(47\) 70 Cal. 2d 327, 450 P.2d 42, 74 Cal. Rptr. 722 (1969).

\(48\) *Id.* at 329, 450 P.2d at 43, 74 Cal. Rptr. at 723.

\(49\) *Id.* at 331-32, 450 P.2d at 45, 74 Cal. Rptr. at 725. Civil Code section 3275 provides:

**RELIEF IN CASE OF FORFEITURE.** Whenever, by the terms of an obligation, a party thereto incurs a forfeiture, or a loss in the nature of a forfeiture, by reason of his failure to comply with its provisions, he may be relieved therefrom, upon making full compensation to the other party, except in case of a grossly negligent, willful, or fraudulent breach of duty.

future. An analysis of the "economic realities of the transaction" revealed that, on the basis of risk allocation, each payment under the option was partly for the right to exercise the option in the year of payment and partly for the right to exercise the option in the remaining years. With the first three installments, the optionee had paid for the right to purchase the option property during the last two years. He would lose this right if the option contract were terminated, and it was this loss which the court saw as a forfeiture under section 3275.

The lessee in Palo Alto could have contended that the rental payments had been made in part to preserve the right to exercise the option to extend the tenancy. Termination of the ability to exercise the option because notice of acceptance was not timely received would visit upon him a loss in the nature of a forfeiture.

An equally cogent argument for relief from a forfeiture in Palo Alto is suggested by the optionee's reliance on extension of the tenancy in making improvements to the option property. The plaintiff in Holiday Inns alleged forfeiture of "great amounts of money" expended for the development of the land adjacent to the option property. Although the court dismissed this supplementary contention, it implied that expenditure of such sums on the option property or expenditures on adjacent property where inclusion of the option property would be necessary to make improvements on that adjacent property a success might justify the finding of a forfeiture if the option were terminated.

The anti-forfeiture rationale of section 3275 is more responsive to the equities of a specific situation than either the "mailing" or the "receipt" rule. As a condition to relief under the statute the optionee must fully compensate the optionor for damages incurred through the latter's reliance on the lapse of the option. The optionor's reasonable expectations under the option will generally be preserved and he will receive the benefit of the bargain as if the option had in fact been properly dispatched and received.

50. 70 Cal. 2d at 330, 450 P.2d at 44, 74 Cal. Rptr. at 724.
51. Id. at 331, 450 P.2d at 45, 74 Cal. Rptr. at 725.
52. Id. at 331-32, 450 P.2d at 45, 74 Cal. Rptr. at 725.
53. Id. at 329, 450 P.2d at 43, 74 Cal. Rptr. at 723.
54. Id. at 332 n.3, 450 P.2d at 45 n.3, 74 Cal. Rptr. at 725 n.3. In Palo Alto, the lessee made long term capital improvements on the option property itself and thus apparently qualified for relief under section 3275.
55. In Palo Alto the lessor apparently showed the disputed premises to several prospective lessees in the period between expiration of the lease and service on BBTC.
Even in the absence of an anti-forfeiture statute some courts of equity have excused the lessee's failure to give timely notice exercising a renewal option. Professor Williston has stated that:

[Where an option is contained in a lease or other contract involving an estate in land, some courts of equity, especially in recent years, have tended to treat the offer as not automatically lapsing on expiration of the option period, as for instance, in case of renewal of a long term lease, where to do so would involve substantial forfeiture and the lessor has not materially changed his position in reliance on the optionee's failure to exercise his option within the stated time.56]

This solution has been favorably received in New York where, in a recent case involving facts very similar to those in Palo Alto, equitable relief was granted a lessee whose notice exercising an option was timely dispatched but, as in Palo Alto, never received by the optionor. In Sy Jack Realty Co. v. Pergament Syosset Corp.57 the court of appeals declared that a tenant should be relieved of its default when its failure to give the requisite timely notice of renewal of its lease—or to perform some other condition precedent to renewal—has neither harmed nor prejudiced the landlord and was not due to bad faith.58 The court in Sy Jack found that only insubstantial harm to the lessor would result from an equitable validation of the option exercise,59 while termination of the option contract would have caused the forfeiture of a "substantial and valuable asset" in the form of the good will appurtenant to a long-established business location.60

An array of arguments favoring application of forfeiture relief is presented in situations such as Palo Alto dealing with leases and other estates in land. Rental payments by the lessee in part preserving the of the notice to surrender the premises. Record at 28-29; Opening Brief for Appellant at v. Preservation of the optionor's reasonable expectations under any negotiations made with potential lessees may require the lessee claiming forfeiture to allow the lessor to receive the benefit of the bargain by an incremental increase in payments to correspond to those negotiated by the lessor with the prospective tenant.


59. 27 N.Y.2d at 453, 267 N.E.2d at 464, 318 N.Y.S.2d at 722.

60. Id.
right to exercise the option will be lost absent such relief. The value of improvements made to the option property in reliance on exercise of the option and the good will attendant to a business location are both jeopardized where exercise of the option is held untimely. *Palo Alto* could have focused on the equities of the transaction and the possible forfeitures involved to ameliorate an otherwise inflexible rule.

**CONCLUSION**

The “effective upon mailing” rule announced by the court does not reflect an integrated or equitable approach to the problem of determining whether an option has been effectively exercised. The rule allocates the risk of nonreceipt to the optionor who, as the probable draftsman of the contract, has the power to control such risks by incorporating an express provision regarding the point at which notice of exercise becomes effective. The probable understanding of the parties to the contract regarding the optionor’s rights and duties is subjugated, however, to the interest of the optionee in obtaining predictability in option transactions. The California court's hasty rejection of the majority rule that notice of exercise of an option is effective upon receipt by the optionor is the result of a disappointing analysis of relevant statutory and decisional law.

Neither the “mailing” nor the “receipt” rule, however, permits a flexible response to the competing equities in a given case. A more flexible approach to option exercise could be achieved through adoption of the “receipt” rule recognized in a majority of jurisdictions tempered by the anti-forfeiture doctrine suggested by *Holiday Inns* and *Sy Jack*. Courts have demonstrated their competence to manage the forfeiture standard, and implementation of this less rigid approach in the option context would open an avenue of judicial response based not only on authority but also on a sense of fairness.

*Michael J. Lawson*

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**C. Third Party Beneficiaries in Government Contracts**

*Martinez v. Socoma Companies, Inc.* The supreme court held that plaintiffs, a group of economically disadvantaged residents of East Los Angeles, lacked standing to sue for damages as third party beneficiaries under economic development contracts between defendant corporations and the federal government. The court construed the contracts as agreements to render services to members of the public.

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Therefore, any rights of third party beneficiaries required explicit expression of an intent to make the promisors liable to third parties, as suggested in section 145 of the Restatement of Contracts. The court's narrow interpretation of the purposes of the contracts leaves the lower courts with uncertain guidelines to follow in the future. This Note will discuss why the court's treatment of the government contracts was incorrect, and it will suggest an alternative analysis which was available and would have provided stronger support for the court's conclusion.

I. THE FACTS

In 1967 Congress established Special Impact Programs under the Economic Opportunity Act of 1964. The purpose of these programs was to alleviate unemployment and poverty in certain designated neighborhoods through government contracts with local private industries to provide job training and employment to hard-core unemployed residents. East Los Angeles was one of these "special impact areas."

In 1969 each of the three defendant corporations entered into a contract with the Secretary of Labor. Each agreed to lease and to renovate a portion of a large building, changing it into a manufacturing facility through capital investments of $5,000,000 each; to hire and train a total of 1600 certified hard-core unemployed for at least one year, paying them minimum wages; and to provide those employees with promotional opportunities and stock options. As consideration for these promises, the Government agreed to pay each corporation between $800,000 and $1,000,000.

Although defendants leased the building as agreed and the Government paid them over $1,250,000, they failed to perform further under their contracts. Plaintiffs brought a class action on behalf of themselves and other certified disadvantaged unemployed residents

2. Section 145 provides:
   A promisor bound to the United States . . . by contract to do an act or render a service to some or all of the members of the public, is subject to no duty under the contract to such members to give compensation for the injurious consequences of performing or attempting to perform it, or of failing to do so, unless, . . . an intention is manifested in the contract, as interpreted in light of the circumstances surrounding its formation, that the promisor shall compensate members of the public for such injurious consequences. . . .
   RESTATEMENT OF CONTRACTS § 145 (1932).

4. 11 Cal. 3d at 398-99, 521 P.2d at 843-44, 113 Cal. Rptr. at 587-88.
5. Defendants Socoma and Lady Fair did provide a total of 276 jobs, but 229 of those hired were then wrongfully terminated. Id. at 399, 521 P.2d at 844, 113 Cal. Rptr. at 588. The court's opinion did not reveal the causes of defendants' nonperformance.
The propriety of the class action was also questioned by defendants. Since there were 417 more class members than jobs available under the contracts, the members had conflicting interests. The court did not reach this issue, since it decided that plaintiffs lacked standing to sue as third-party beneficiaries.

6. The propriety of the class action was also questioned by defendants. Since there were 417 more class members than jobs available under the contracts, the members had conflicting interests. The court did not reach this issue, since it decided that plaintiffs lacked standing to sue as third-party beneficiaries.

7. 11 Cal. 3d at 399, 521 P.2d at 844, 113 Cal. Rptr. at 588.
12. 11 Cal. 3d at 400, 521 P.2d at 845, 113 Cal. Rptr. at 589.
13. RESTATEMENT OF CONTRACTS § 133(1)(a) (1932).
14. 11 Cal. 3d at 401, 521 P.2d at 845, 113 Cal. Rptr. at 589. Justice Burke was unpersuaded by the majority's conclusion that plaintiffs were not the recipients of a gift. He found that the benefits to be conferred met the Restatement's definition of a gift as "some performance or right which is not paid for by the recipient and which is apparently designed to benefit him." Id. at 412 & n.3, 521 P.2d at 853 & n.3, 113 Cal. Rptr. at 597 & n.3 (citing RESTATEMENT OF CONTRACTS, comment c to § 133 (1932)).
fact that the third persons were intended to enjoy the benefits.” The court decided that providing plaintiffs with employment was only a "means" of accomplishing a larger public purpose—the alleviation of unemployment.

The court held that contracts with such a purpose are governed by section 145 of the Restatement of Contracts, which provides that a contract with the government to render services to the public is not enforceable by third parties unless it manifests the intent to give third parties such a right. After examining the provisions of the contract, the court concluded that there was no such manifestation of intent. It relied on the dispute resolution procedures and the provisions for liquidated damages contained in the contract and reasoned that these provisions were inconsistent with an intent to provide for enforcement by third parties.

The dissenters disagreed with this narrow interpretation of the contracts and contended that their purpose was to benefit both the public generally and plaintiffs in particular. The intent to benefit plaintiffs and the class they represented made section 145 inapplicable:

The express language of this provision indicates that it applies only to a promise to do an act or render a service to "some or all of the members of the public." The type of government contract to which section 145 applies is therefore distinguishable from the contracts in the instant case. Here, the contracts specify a particular class of persons who are to receive a direct benefit. The beneficiaries of these contracts are to receive the promised performance because of their membership in a particularly defined and limited class and not simply because they are members of the public in general.

Accordingly, the dissent concluded that plaintiffs were entitled to recover as donee beneficiaries within the meaning of section 133 of the Restatement.

III. THE APPLICABILITY OF RESTATEMENT OF CONTRACTS SECTION 145

The basic premise underlying the majority's opinion is that the contracts in question were designed to benefit or render services to

15. 11 Cal. 3d at 401, 521 P.2d at 845, 113 Cal. Rptr. at 589.
16. Id. at 404-06, 521 P.2d at 848-49, 113 Cal. Rptr. at 592-93.
17. RESTATEMENT OF CONTRACTS § 145 (1932). The majority asserts that corresponding language in the Tentative Drafts of Restatement Second of Contracts (1973), section 145, also supports its position. 11 Cal. 3d at 402 n.2, 521 P.2d at 846 n.2, 113 Cal. Rptr. at 590 n.2.
18. 11 Cal. 3d at 403, 521 P.2d at 846, 113 Cal. Rptr. at 590.
19. Id. at 409, 521 P.2d at 851, 113 Cal. Rptr. at 595.
20. Id. at 411-12, 521 P.2d at 853, 113 Cal. Rptr. at 597.
21. Id. at 412-13, 521 P.2d at 853, 113 Cal. Rptr. at 597.
members of the public, and thus, that they fall under section 145 of the Restatement. In reaching this conclusion, the majority relied on congressional declarations of purpose in the Equal Opportunity Act and the Special Impact Programs which emphasized goals of improving the economic and social health of the nation and of particularly disadvantaged neighborhoods.

This focus on the language of the enabling legislation ignored the nature of the contracts themselves. The preamble to each contract clearly stated both the need to help disadvantaged neighborhoods and the need to aid the hard-core unemployed, thereby giving the contracts a dual purpose. This is the more reasonable interpretation of the contracts adopted by the dissent:

These direct benefits to members of plaintiffs' class were not merely the "means of executing the public purposes," as the majority contend, but were the ends in themselves and one of the public purposes to which the legislation and subsequent contracts were addressed.

Parties contracting under the authority of a program designed "to help find jobs and provide training for thousands of the Nation's hard-core unemployed..." must intend to confer a benefit upon certain designated unemployed persons. The majority, however, unnecessarily restricted the purpose of the contracts to general improvement of economic conditions.

In holding that the benefit to the plaintiffs was merely incidental to the overall contract purpose, the majority placed heavy reliance on

22. The majority contended that, even if section 145 is not applicable, section 133 still precluded recovery by plaintiffs since there was no contractual intent to make a gift or to give plaintiffs a right against the promisor. *Id.* at 404, 521 P.2d at 847-48, 113 Cal. Rptr. at 591-92. The majority did not comment upon Justice Burke's contention that the benefits were a gift. See note 14 *supra*.

23. 11 Cal. 3d at 404-06, 521 P.2d at 848-49, 113 Cal. Rptr. at 592-93.

24. The contracts provided:

*WHEREAS*, the Secretary of Labor is authorized ... to enter into contracts to provide for Special Impact Programs ... directed to the solution of the critical problems existing in particular communities and neighborhoods within urban areas of the Nation having especially large concentrations of low-income persons and

*WHEREAS*, the President of the United States on October 2, 1967 launched a major test program to mobilize the resources of private industry and the Federal Government to help find jobs and provide training for thousands of the Nation's hard-core unemployed, or underemployed, by inviting private industry throughout the country to join with the agencies and departments of the Federal Government in assuming responsibility for providing training and work opportunities for such seriously disadvantaged persons.

Now *THEREFORE*, pursuant to the aforesaid statutory authority, and the directive of the President, the parties hereto, in consideration of the mutual promises herein expressed, agree as follows ... *Id.* at 409-10, 521 P.2d at 851, 113 Cal. Rptr. at 595 (emphasis added).

25. 11 Cal. 3d at 409, 521 P.2d at 851, 113 Cal. Rptr. at 595 (Burke, J., dissenting) (citation omitted) (emphasis in original).

26. 11 Cal. 3d at 409, 521 P.2d at 851, 113 Cal. Rptr. at 595.
City and County of San Francisco v. Western Air Lines, Inc.\textsuperscript{27} Western Air Lines was partially based on section 145 of the Restatement and exemplifies the type of contract contemplated by that section. The contract there involved an agreement by the City and County of San Francisco to operate the airport for the “use and benefit of the public on fair and reasonable terms and without unjust discrimination.”\textsuperscript{28} In return San Francisco received aid under the Federal Airport Act of 1946.\textsuperscript{29} Western Air Lines, suing on a counterclaim, asserted that it had been the victim of unjust rate discrimination and claimed a right to recover as a third party beneficiary to the government contract. The court of appeal found that the purpose of the Federal Airport Act was to promote a nationwide system of public airports and not to regulate specific airport operations. The agreement between the city and the Government was a financial arrangement solely between those two parties. There was no intent to benefit a defined group of persons not party to the contract, and there was no provision permitting the recovery of excess rates by a third party. Citing section 145, the court held that Western Air Lines may have incidentally benefited from the contract but that there was no intention manifested in the contract for the promisor to compensate any “members of the public” in event of breach.\textsuperscript{30}

Shell v. Schmidt,\textsuperscript{31} however, also involved third party beneficiaries to a government contract and did not apply section 145 of the Restatement.\textsuperscript{32} There, under the Veterans’ Emergency Housing Act of 1946, the Government had granted priority for building materials to a contractor in exchange for his agreement to meet certain specifications in the construction of homes for veterans. The court held that the plain-

\textsuperscript{27} 204 Cal. App. 2d 105, 22 Cal. Rptr. 216 (1st Dist. 1962), \textit{cert. denied}, 371 U.S. 953 (1963). This was the first California case involving a government contract to cite section 145.

\textsuperscript{28} 204 Cal. App. 2d at 118, 22 Cal. Rptr. at 224.

\textsuperscript{29} 49 U.S.C. §§ 1101-19 (1946).

\textsuperscript{30} The contract in \textit{Western Air Lines} illustrates why section 145 was needed to qualify the broad definition of donee beneficiary in section 133. Otherwise, any member of the public could qualify as an intended beneficiary under a government contract in which the promisor renders a service to the general public. Such a result would greatly discourage private enterprise from contracting to engage in any public service. Section 145 makes members of the public incidental beneficiaries with no right of recovery for breach of contract unless the contract manifests a clear intent that the promisor should compensate them.


\textsuperscript{32} The majority distinguished \textit{Shell} on the grounds that the contracts there contained a clause providing for indirect compensation for veterans who purchased homes from contractors who had breached their obligations. The majority concluded that such a clause constituted the manifest intention to confer a right against the promisor required by section 145. 11 Cal. 3d at 403, 521 P.2d at 847, 113 Cal. Rptr. at 591.
tiffs—veterans who had purchased homes—had standing to sue as third party beneficiaries, because they were part of the class of beneficiaries whom the Government as promisee intended to benefit through its contract.

The government contracts in Martinez likewise specified a particular class of beneficiaries: disadvantaged hard-core unemployed individuals from special impact areas. Those contracts bear a closer resemblance to the one at issue in Shell than to the agreement in Western Air Lines. Since section 145 only applies to those contracts directed to the public at large, the plaintiffs here should not have been barred from claiming to be donee beneficiaries under the broader terms of section 133.

IV. "ACCOMPANYING CIRCUMSTANCES" UNDER RESTATEMENT OF CONTRACTS SECTION 133

Even if section 145 was inapplicable to the contracts under consideration, plaintiffs still had to demonstrate under section 133 that "in view of the accompanying circumstances... the purpose of the promisee in obtaining the promise... [was] to make a gift to the beneficiary or to confer... a right against the promisor...." Indeed, any cause of action under California Civil Code section 1559 depended upon plaintiffs' satisfaction of this general provision.

If we accept the majority's conclusion that the benefits plaintiffs were to receive had not been intended as gifts, plaintiffs still needed to show, "in view of the accompanying circumstances," that the Government had intended to confer on them a right against the promisor. Contractual provisions for recovery of damages are circumstances which provide significant evidence of whether a promisee intended to confer an enforceable right on third parties.

In Shell v. Schmidt, a compensation provision in section 7 of the Veterans Emergency Housing Act was a major consideration in favor of plaintiffs' recovery. There, the Government was given the power to prosecute violators and to obtain monetary compensation for veterans who purchased from contractors who had failed to comply with the specifications. Although a statute of limitations prevented recovery under section 7, this compensation provision helped persuade the court that the veterans were third party beneficiaries with enforceable rights. In Western Air Lines, on the other hand, where the contract only pro-

33. Restatement of Contracts § 133(1)(a) (1932).
34. See note 11 supra and accompanying text.
vided for recovery of the Government's own payments, the court held that plaintiff was an incidental beneficiary.

In *Martinez*, the contracts contained liquidated damages provisions which, in the case of total default, limited the liability of the promisor corporations to refunding, with interest, the consideration received from the government; in the case of partial default, a stated amount was to be refunded for each employment opportunity the companies failed to provide. This provision was much closer to the one in *Western Air Lines* than the one in *Shell v. Schmidt*.

There are strong policy reasons for holding that such limited liability was the only remedy contemplated by the contracting parties and that the Government did not intend to confer a right to another remedy upon these plaintiffs. A liability "ceiling" was essential to the success of the government programs, because unlimited liability was a major deterrent to participation by private industry.36

More important than the desire to protect negotiated risks under the contracts and to attract private industry is the concern that the purposes of the Economic Opportunity Act, the Special Impact Programs, and the contracts themselves would be frustrated by the award of monetary compensation in lieu of performance. The purpose of the Act was "to eliminate the paradox of poverty in the midst of plenty in this Nation by opening to everyone the opportunity for education and training, the opportunity to work, and the opportunity to live in decency and dignity."37 The Special Impact Programs were "directed to the solution of the critical problems existing in particular communities or neighborhoods... within those urban areas having especially large concentrations of low-income persons..."38 and were intended to be "of sufficient size and scope to have an appreciable impact in such communities and neighborhoods in arresting tendencies toward dependency, chronic

36. [T]he only method by which the Federal Government could attract substantial private corporations to participate in the Special Impact Programs was to provide them with such a ceiling of maximum liability, thus insuring protection from astronomical damage claims by intended recipients or beneficiaries of the Program. To fail to provide this protection would have been to dissuade private companies from participation in the program out of the fear that third party beneficiary suits by a class of the literally thousands of intended beneficiaries of the Program would not only inundate the participating corporation but would financially bankrupt it.


37. 42 U.S.C. § 2701 (1964). The statement of purpose was amended in 1966 to recognize that "it is highly desirable to employ the resources of the private sector of the economy of the United States in all such efforts to further the policy of this chapter." Act of Nov. 8, 1966, Pub. L. No. 89-794, Title VI, § 614(b), 80 Stat. 1472.

unemployment, and rising community tensions." Monetary damages would defeat the long-range objectives of the contracts, to provide permanent industries in which local residents would find permanent employment and have the opportunity to become supervisors and stockholders.\textsuperscript{40} Compensation to third parties for the failure to perform by the defendants would have amounted to nearly $9,000,000 under the plaintiffs' calculations.\textsuperscript{41} This would have constituted a windfall recovery, which courts generally try to avoid.

Professor Corbin stated that contracting parties can expressly provide by contract that some third party who will be benefited by performance shall have no legally enforceable right, and that the court should deny that third party any direct remedy.\textsuperscript{42} While the government contracts in this case did not explicitly deny the plaintiffs a legally enforceable right against the promisors, the liquidated damages provisions and policy arguments seem to compel that conclusion. Similar arguments should also deny plaintiffs' claim to any enforceable rights they may have as recipients of a gift from the Government. Thus, although section 145 is inapplicable to these government contracts, plaintiffs have no standing to sue under section 133 as donee beneficiaries.

CONCLUSION

The California Supreme Court in \textit{Martinez v. Socoma Companies} limited the application of California Civil Code section 1559 and overextended Restatement of Contracts section 145. It left uncertain the criteria for determining who is an intended third party beneficiary in a government contract.

The enabling legislation and contractual language indicate that these government contracts do not fall under section 145, which deals with services rendered to the general public. There is a manifest intent to benefit a distinct class of persons—those certified as disadvantaged hard-core unemployed in the East Los Angeles area. Yet, the majority insists that section 145 is controlling. The court's holding would require in any government contract an explicit expression of the Government's intent to benefit certain members of the public before those persons can recover.

The case would have been better decided on the grounds that a consideration of the accompanying circumstances of the contracts, as re-

\textsuperscript{39} Id.

\textsuperscript{40} The minimum capital investment of $5,000,000 required from each promisor and the long-term lease of the jail building for use as a manufacturing facility are indications of these broad objectives.

\textsuperscript{41} 11 Cal. 3d at 399, 521 P.2d at 844, 113 Cal. Rptr. at 588.

\textsuperscript{42} 4 A. CORBIN, CONTRACTS § 777 (1951).