

RESCISSION OF CONTRACTS IN CALIFORNIA



Rescission of Contracts - General Concepts

Rescission is a remedy that disaffirms the contract (Ca Civil § 1688 et seq.). The remedy assumes the contract was properly formed, but effectively extinguishes the contract ab initio as though it never came into existence; and its terms cease to be enforceable. [Ca Civil § 1688]

A finding that there never was a meeting of the minds on the essential terms--i.e., that the parties lacked contractual intent--means that no contract was formed. If money has changed hands, or one party has taken possession, there may be an equitable remedy. But there is no remedy of rescission, "[s]ince a contract cannot be rescinded if it has never been formed." [Hedging Concepts, Inc. v. First Alliance Mortgage Co. (1996) 41 Cal.App.4th 1410, 1417-1418, 49 Cal.Rptr.2d 191, 196]

A contract can be rescinded by the parties' mutual agreement or unilaterally by a party upon proper grounds.. In turn, an "action for rescission" is actually a suit to enforce the rescission by seeking appropriate relief (i.e., a return to the status quo) based upon rescission.

Grounds for rescission may also support other contract remedies; but, because rescission is predicated on a disaffirmance of the contract, it is inconsistent with a damages suit for breach of contract or fraud, a reformation suit, or a specific performance suit, all of which effectively affirm the contract. Nonetheless, absent a waiver, plaintiff may plead and pursue alternative remedies (assuming they are based on consistent facts) and is not finally put to an election of remedies until the case has proceeded through trial and all evidence has been presented. [See Ca Civil § 1692]

Grounds for Rescission

Mutual Consent Of The Parties: A contract may always be rescinded upon the mutual consent of the parties thereto. But rescission at only one party's behest requires proper notice on statutory grounds and, if necessary to adjust the equities, a court action to enforce the rescission. [Ca Civil §§ 1689, 1691, 1692]

The parties' consent need not be in writing, even if the contract to be

rescinded was required by the statute of frauds to be in writing. A consensual rescission may occur by the parties' oral agreement; or it can be implied from their unequivocal conduct that is inconsistent with continued existence of the contract. [Martin v. Butter (1949) 93 Cal.App.2d 562, 565-566, 209 P.2d 636, 638; Bush v. Vernon (1955) 135 Cal.App.2d 33, 36-37, 286 P.2d 903, 906; see Unger v. Isaacs (1954) 123 Cal.App.2d 533, 535, 266 P.2d 869, 870--sale agreement impliedly rescinded by subsequent execution of inconsistent exchange agreement]

Unilateral Rescission On The Basis Of Mistake, Fraud, or Duress: A contract is subject to unilateral rescission by a party whose consent to the contract (or the consent of another party jointly contracting with the rescinding party) was given by mistake or obtained through duress, fraud or undue influence exercised by or with the connivance of the party against whom rescission is sought or any other party to the contract jointly interested with the party against whom rescission is sought. [Ca Civil § 1689(b)(1)]

The wrongful acts of third persons who are not parties to the contract may support an action for rescission if the party against whom the rescission is sought had knowledge of the wrongdoing before parting with consideration for the contract. Under the court's broad equitable power, rescission may also lie against a contracting party who was entirely innocent of any wrongdoing but simply a "conduit" through whom a third party's fraud was perpetrated.

Consent Mistakenly Given: Rescission may be granted in favor of a party whose consent to the contract was given under a material "mistake of fact" or "mistake of law." [Ca Civil § 1576]

Mistake Of Fact: A party gives consent under a "mistake of fact" when, not because of his or her "neglect of a legal duty", he or she (i) is ignorant of or has forgotten a past or present fact material to the contract, or (ii) believes in the present existence of something material to the contract, which does not exist, or in the past existence of something which never existed. [Ca Civil § 1577]

In effect, this type of mistake relates to an erroneous belief about an objective existing or nonexisting fact material to the contract.

Unilateral Mistake Of Fact: Rescission for a unilateral mistake of fact is authorized where "the effect of the mistake is such that enforcement of the contract would be unconscionable." In such cases, it need not be shown that the opposing (nonrescinding) party caused or even knew of the mistake.

In determining whether rescission is warranted for a unilateral

mistake of fact, substantive rather than procedural unconscionability is often the determinative factor, because the oppression and surprise ordinarily results from the mistake-- not from inequality in bargaining power.

Limitation - No Rescission For Party Bearing The Risk Of The Mistake: Rescission is unavailable to a contracting party who bears the risk of the mistake at issue. A party bears the risk of a mistake when (i) the risk is allocated to the party by the contract; or (ii) the party is aware when the contract is made that he or she has only limited knowledge regarding facts to which the mistake relates, but treats that limited knowledge as sufficient; or (iii) it is reasonable under the circumstances to allocate the risk to the party. [Donovan v. RRL Corp., supra, 26 Cal.4th at 283, 109 Cal.Rptr.2d at 825; Rest.2d Contracts § 154]

Rescission where unilateral mistake of fact unknown to non-rescinding party: Rescission on the basis of a unilateral mistake of fact is not barred by the fact the other party was unaware of the mistake. However, where the nonrescinding party had no reason to know of and did not cause the other party's unilateral mistake of fact, the following must be established to obtain rescission:

- the mistake concerns a basic assumption upon which the contract was made;
- the mistake has a material effect on the agreed exchange of performances under the contract that is adverse to the rescinding party;
- the rescinding party does not bear the risk of the mistake; and
- the effect of the mistake is such that enforcement of the contract would be unconscionable.

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

A mistake of law exists only when (i) all parties think they know and understand the law but all are mistaken in the same way, or (ii) one side misunderstands the law at the time of contracting and the other side knows the correct law but does not rectify the other party's misunderstanding. [Ca Civil § 1578]

The fact that one of the parties subjectively misunderstood his or her contractual duties or other contractual terms, or that both parties had differing subjective understandings of the contract from its inception, does not warrant rescission based on mistake of law.

Unlike cases where a party's "neglect of a legal duty" precludes rescission or reformation based on a mistake of fact, "freedom from negligence" is not a prerequisite to rescission based on a mistake of law. This is because Ca Civil § 1578 makes no reference to "negligence." [Harris v. Rudin, Richman & Appel, supra, 95 Cal.App.4th at 1341, 116 Cal.Rptr.2d at 559]

Duress Or Undue Influence: Courts consider a variety of factors in determining whether the rescinding party's consent was procured through duress or undue influence, including:

- the adequacy of the consideration involved;
- whether the rescinding party acted with a free mind;
- whether the contract was negotiated at arm's length; and
- whether the parties to the contract were in a confidential relationship.

Fraud: The type of "fraud" sufficient to support a unilateral rescission may be either an "actual fraud" (misrepresentation with intent to deceive) or a "constructive fraud" (misleading conduct without fraudulent intent to the prejudice of the other party). A presumption of constructive fraud may arise where there is inadequate consideration for the rescinding party's performance and especially where the parties are in a confidential relationship. [Ca Civil § 1572 (defining "actual fraud") & § 1573 (defining "constructive fraud")]

Even an innocent misrepresentation, made in good faith and with a reasonable belief in its truth, may provide a basis for rescission if it related to a material fact upon which the rescinding party relied in consenting to the contract. Although neither a specifically-enumerated ground for rescission nor the equivalent of "fraud," innocent misrepresentation supports rescission as a type of "mistake".

Whereas proof of damages is an essential prerequisite to a fraud cause of action seeking damages, a defrauded party has the right to rescind a contract even without a showing of pecuniary damages. The rule derives from the basic principle that a contracting party has a right to what it contracted for, and so has the right to rescind where he obtain[ed] something substantially different from that which he [is] led to expect.

Since the goal of rescission is to restore the parties to the pre-contract status quo, courts ordinarily will not grant relief based upon rescission where the rescinding party is unable to restore substantially all of the consideration he or she received under the contract--i.e., unless the contract is divisible because supported by severable consideration, it cannot be "partially rescinded." However, this rule may be relaxed in cases of fraud. Here, even though the contract is not severable and the innocent party cannot restore the identical consideration, courts may grant a partial rescission that nonetheless produces an equitable result.

Failure Of Consideration: A unilateral rescission can be based on a failure of consideration in three situations (Ca Civil § 1689(b)(2),(3) &(4)):

- Where the consideration for the rescinding party's obligation fails, in whole or in part, through the fault of the other party to the contract (Ca Civil § 1689(b)(2));
- Where the consideration for the rescinding party's obligation becomes entirely void from any cause (Ca Civil § 1689(b)(3)); or
- Where the consideration for the rescinding party's obligation fails in a material respect from any cause before it is rendered (Ca Civil § 1689(b)(4)).

Illegality: A contract is subject to unilateral rescission if it is unlawful "for causes which do not appear in its terms and conditions" and "the parties are not equally at fault." [Ca Civil § 1689(b)(5)]

Public Interest: A party may also rescind a contract where its enforcement would be prejudicial to the public interest. [Ca Civil § 1689(b)(6)--"(i)f the public interest will be prejudiced by permitting the contract to stand"]

Particular Statutory Grounds: Ca Civil § 1689 incorporates by reference several other statutes providing a basis for rescission in particular contractual relationships and also includes a "catch-all" provision recognizing a party's right to rescind under "any other statute providing for rescission" (see Ca Civil § 1689(b)(7)).

Notice Requirement for Unilateral Rescission:

A party intending to effect a unilateral rescission must give notice to the other party promptly upon discovering the facts entitling him or her to rescind (provided the aggrieved party is "free from duress, menace, undue influence or disability" and is aware of the right to rescind at that time). [Ca Civil § 1691(a)] The notice itself effects the unilateral

rescission. Thereafter, the rescinding party is entitled to bring an action to obtain relief based upon the rescission (or, viewed another way, an action to enforce the rescission). Though technically a prerequisite to filing suit based upon rescission, if the notice has not otherwise been given, plaintiff's service of the complaint seeking rescission "shall be deemed to be" the requisite notice. [Ca Civil § 1691]

Despite the statutory requirement that notice of rescission be given "promptly" (above), delay in providing timely notice will amount to a waiver of the right to relief based upon rescission only if the delay has substantially prejudiced the other party. [Ca Civil § 1693] In effect, this amounts to a laches defense: "[R]easonable diligence or promptness on the part of the party seeking rescission is [not] . . . a prerequisite for the remedy. The . . . requirement is essentially one of freedom from laches. Its application depends on whether, under the particular facts, the delay has in any way prejudiced the defendant. No waiver will be found where the delay is justified under the facts--e.g., pursuit of settlement negotiations after discovery of one party's fraud, or reliance on the other party's promise to make the aggrieved party "whole.

A party may waive the right to rescind by words or actions indicating an affirmance of the contract after learning of the facts entitling him or her to rescind. A waiver commonly occurs by accepting the benefits of the contract after knowledge of the facts warranting rescission. A party wishing to rescind "cannot play fast and loose. He cannot conduct himself so as to derive all possible benefit from the transaction and then claim the right to rescind . . . Waiver of a right to rescind will be presumed against a party who, having full knowledge of the circumstances which would warrant him in rescinding, nevertheless accepts and retains benefits accruing to him under the contract." [Neet v. Holmes (1944) 25 Cal.2d 447, 457-458, 154 P.2d 854, 859; see Saret-Cook v. Gilbert, Kelly, Crowley & Jennett (1999) 74 Cal.App.4th 1211, 1226, 88 Cal.Rptr.2d 732, 743]

However, there is no such waiver if the acts indicating affirmance of the contract were induced by the other party's fraud. Continued acceptance of the benefits of the contract after giving notice of rescission does not waive the right to relief based upon rescission if the other party has rejected the notice of rescission. In such event, the rescinding party may continue to accept the benefits until the action for rescissionary relief is concluded.

Nor does a party waive the right to rescind by bringing an action based upon rescission or damages for breach of contract in the alternative. Though the remedies are inconsistent (rescission disaffirms the contract, while a damages suit affirms it), the aggrieved party is not put to a final election of remedies until after a trial upon presentation of the evidence.

[Ca Civil § 1692] On the other hand, a party may be deemed to have waived its right of rescission by bringing an action exclusively for damages or specific performance (i.e., waiver by conduct unequivocally affirming the contract). [Price v. McConnell (1960) 184 Cal.App.2d 660, 665-666, 7 Cal.Rptr. 695, 698]

A notice of rescission remains revocable up until the time that the rescinding (innocent) party receives restitution of the benefits (consideration) parted with.

Restoration of Consideration:

In addition to giving prompt notice of rescission, the party seeking rescissionary relief must "promptly," upon discovering the facts entitling him or her to rescind, restore to the other party "everything of value" received under the contract or offer to restore the benefits received "upon condition that the other party do likewise" . . . unless the other party "is unable or positively refuses to do so." [Ca Civil § 1691(b)] This restoration of benefits accomplishes the ultimate purpose of rescission-- i.e., to return the parties to their precontract status quo positions. Thus, in a real property purchase and sale transaction, a rescission normally requires the buyer to return the property (title) to the seller and the seller to return the funds received from the buyer.

A formal offer to restore the contractual benefits received is not required. Plaintiff's service of the complaint seeking rescissionary relief "shall be deemed" to be the requisite offer. [Ca Civil § 1691]

As with the notice of rescission, a delay in restoring the benefits received under the contract or in tendering such restoration does not waive the right to relief based upon rescission unless the delay substantially prejudices the other party (again, the issue is essentially one of laches; However, the court may condition its judgment awarding relief on plaintiff's tender of restoration. [Ca Civil § 1693]

Relief Based Upon Rescission:

In an action based upon rescission, courts may order whatever relief is necessary to adjust the equities between the parties and ensure restoration to the pre-contract status quo. [Ca Civil § 1692] The goal is to reach an equitable result by returning the parties to the position they were in before the contract was entered into and avoiding unjust enrichment. Therefore, such additional relief may operate in favor of either or both parties.

For example, the court may order a restitution of benefits conferred by the rescinding party and also award him or her consequential damages

incurred as a result of entering into the contract (so long as the award does not include a double or inconsistent recovery). The court may also award compensation or other equitable relief to the non-rescinding party (e.g., an offset for the value of the rescinding party's use of the property). [Ca Civil § 1692]

The authority to "adjust the equities" does not empower the court to provide either party with greater relief than he or she would have realized had the contract been affirmed. A court cannot, in the name of "adjusting the equities," rewrite the terms of the parties' contract. Thus, e.g., relief based upon rescission pursuant to Ca Civil § 1692 cannot include an award of compensation that was subject to a contractual contingency which never occurred.

Consequential damages in the rescinding party's favor may include all out-of-pocket expenses incurred in reliance on the contract--including, e.g., escrow fees, title charges, the value (or cost) of any improvements made to the property, payments made by a rescinding buyer on a mortgage imposed by the seller, and attorney fees (if authorized by the rescinded contract).

A rescinding buyer is entitled to prejudgment interest on contract payments made to the seller (net of liquidated offsets awarded to the seller), running from the date of notice of the rescission. The interest is awardable under Ca Civil § 3287(a), providing for prejudgment interest as a matter of right on damages that are certain or capable of ascertainment.

Ca Civil § 1692 expressly states that in an action to enforce a rescission, the aggrieved party "shall be awarded complete relief"; and it also states that a "claim for damages is not inconsistent with a claim for relief based upon rescission." [Ca Civil § 1692] Thus, where the rescission is based upon fraud, and provided plaintiff (rescinding party) satisfies the applicable statutory standards (Ca Civil § 3294), the court apparently has discretion to award the rescinding party punitive damages. [See Mahon v. Berg (1968) 267 Cal.App.2d 588, 589-590, 73 Cal.Rptr. 356, 357-358]

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