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“An option based on consideration, whether it be the ‘proverbial peppercorn’ or some other detriment, is itself a binding contract and is mutually enforceable.”

Disguised Option Agreements**THIS ISSUE**

When does an option to purchase real property become an enforceable contract of sale? Can an option agreement be unilaterally cancelled?

BACKGROUND

A recently decided case from the California Court of Appeals reviewed the law of options in real property purchase agreements, and confirmed longstanding law that an option to purchase a property, unsupported by any other consideration at the time of the option, may be terminated at any time prior to final consummation of the transaction.

In *Steiner v. Thexton*, the plaintiff was a property developer. He sought to purchase about 10 acres of land from Mr. Thexton, who had been reluctant to sell, but ultimately agreed. Mr. Steiner drafted a purchase agreement that allowed him to fully investigate the land, determine if it could be subdivided, engage in the process of obtaining county permits and approvals, and otherwise take steps toward property development. Mr. Thexton agreed to cooperate in that process. Mr. Steiner, however, retained the right to terminate the transaction at any time, if he determined that the property did not meet his needs. He agreed that if he terminated the purchase agreement, he would deliver all of the work undertaken on the property up to that point to Mr. Thexton. In addition, Mr. Steiner opened an escrow account and deposited \$1,000 into that account as a deposit, to be credited toward the purchase price of the property. The agreement was labeled “REAL ESTATE PURCHASE AGREEMENT.”

Mr. Thexton had second thoughts about the sale, and contacted the title company to terminate the agreement. Mr. Steiner sued Mr. Thexton for specific performance of the contract.

DECISION AFTER TRIAL

The trial court entered judgment in the defendant's favor, finding that the sale agreement was merely an option to purchase the property and was properly terminated by Mr. Thexton prior to becoming binding on him. The plaintiff appealed, contending that (1) this was actually a contract for sale, not an option agreement, (2) the considerable work he performed toward the development of the property was adequate consideration for the property and it would be inequitable to allow Mr. Thexton to retain that work, and (3) the deposit into escrow was sufficient consideration to bind Mr. Thexton to the purchase agreement.

WHAT IS AN OPTION AGREEMENT?

An option to purchase property is "a unilateral agreement. The optioner offers to sell the subject property at a specified price or upon specified terms and agrees, in view of the payment received, that he will hold the offer open for the fixed time. Upon the lapse of that time the matter is completely ended and the offer is withdrawn. If the offer be accepted upon the terms and in the time specified, then a bilateral contract arises which may become the subject of a suit to compel specific performance, if performance by either party thereafter be refused."

There is a difference between an option and the exercise of the option which results in a contract of purchase and sale. Thus, "[a]n option may be viewed as a continuing, irrevocable offer to sell property to an optionee within the time constraints of the option contract and at the price set forth therein. It is, in other words, a unilateral contract under which the optionee, for consideration he has given, receives from the optioner the right and the power to create a contract of purchase during the life of the option. 'An irrevocable option is a contract, made for consideration, to keep an offer open for a

prescribed period.' [Citation.] An option is transformed into a contract of purchase and sale when there is an unconditional, unqualified acceptance by the optionee of the offer in harmony with the terms of the option and within the time span of the option contract.

To be enforceable, an option, like any contract, must have consideration. Thus, an agreement for an option not based upon consideration is simply a continuing offer which may be revoked at any time. And by contrast, an option based on consideration, whether it be the "proverbial peppercorn" or some other detriment, is itself a binding contract and is mutually enforceable.

In other words, an option based on consideration contemplates two separate contracts: the option contract itself, which for something of value gives to the optionee the irrevocable right to buy under specified terms and conditions, and the mutually enforceable agreement to buy and sell into which the option ripens after it is exercised. Thus, an irrevocable option based on consideration is a contract.

On the other hand, an option without consideration is not binding on either party until actually exercised, and is not a contract in the traditional sense. In short, an option given without any consideration contemplates only one contract, the one which comes into existence after it is exercised. Thus, until exercised, such an option is merely a continuing offer which may be revoked at any time.

RULING ON APPEAL

The court of appeal confirmed the trial court's judgment, finding that they parties had merely entered into what the court called a "disguised option agreement," which could be cancelled by either of them at any time.

The court of appeal found that the agreement was an (attempted) option in which defendant bound himself to sell on specified terms and left it discretionary with Steiner whether he would or would not buy the property.

The plaintiff argued the contract required Thexton to keep the property off the market only as long as the plaintiff moved forward "expeditiously" with the government approvals. But despite the plaintiff's assertion that Thexton could have sued if he failed to act expeditiously, the promise to act "expeditiously" was an unenforceable promise, since the agreement did not require plaintiffs to move forward at all. The same applies to Steiner's promise to pay for the investigations and applications for the county approvals. This was an unenforceable promise because he had to pay only if he went forward seeking the county approvals. The agreement did not require him to move forward.

The trial court found plaintiff paid nothing other than \$1,000 into escrow, but that money was not paid for the grant of an option. The "contract" expressly stated such payment was to be applied to the purchase price. If no purchase took place, the money would go back to plaintiff upon termination of escrow.

The plaintiff argued that even though the \$1,000 was to be paid back in the event he terminated the purchase, there was other consideration. He asserted that he conducted the investigations, at his own expense, and the contract called for him to turn over the results to Thexton, such that Thexton benefitted from plaintiff's efforts. But the agreement did not require him to conduct the investigations at all. The court held that the adequacy of consideration must be determined *as of the date of the agreement*, and not at the time of performance.

As of the date the agreement was executed, the agreement did not require plaintiff to do anything

(other than pay the deposit toward the purchase price). The agreement stated, "It is expressly understood that the Buyer may, at its absolute and sole discretion during this period, elect not to continue in this transaction and this purchase contract will become null and void." Thus, the agreement required Steiner to assume the expense of the parcel split, but only if he chose to do so. This, the court held, does not constitute consideration for the option.

WHY IS THIS IMPORTANT?

There are numerous kinds of option agreements, two of which are outlined here: a terminable option, and a non-terminable option. Options may be for a specified period of time, may expire upon the happening of a certain event, and may even simply disappear if not exercised exactly as set forth in a contract. It is vitally important for those who wish to rely upon the enforceability of an option to exercise the option exactly as required by the contract.

And what about that "proverbial peppercorn"? Though often recited, it is doubtful that a court would consider this to be adequate consideration to enforce an option agreement. But why a peppercorn? It was said that one could gain a tremendous amount from a peppercorn: a full tree, an entire crop of pepper, perhaps even an entire orchard and an industry based upon that orchard. Thus, like the option that could be very valuable or entirely worthless, a peppercorn might have long-term benefits that are unknowable today. Still, if you wish to enforce an option later, you should offer something more tangible to ensure your success.

CONCLUSION

Unilateral options are unenforceable until they are fully performed.

NEXT ISSUE

Protecting arbitration rights in lien proceedings.

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