Cosmic Contracts: How Can an Entity Enforce a Real Estate Contract When the Entity Did Not Exist When the Contract Was Made?

This time we look at a refreshingly short, recent opinion of the California Court of Appeal for the Second Appellate District (covering Los Angeles). The case is about an abortive sale of a hotel –a mere six pages worth of legal wisdom and guidance! The case illustrates a truly *metaphysical* proposition in the law --right up there with the classic:' if a tree falls in the forest and nobody is there to hear it, does it make a noise?'—but, nonetheless, one which is quite important to be familiar with for any reader of this periodical who has more than a passing fancy for real estate.

The charmingly impersonal name of the case is ***02 Development, LLC v. 607 South Park, LLC.*** This reflects our modern penchant for forming (sometimes multiple) entities for real estate conveyancing and using somewhat less than inspiring names for those entities- you won't find names like these in the old case books. At trial, the Court granted Summary Judgment in favor of 607 South Park (the Seller) in a lawsuit brought by 02 Development (the Buyer) for breach of an agreement to buy and sell, respectively, a hotel property. Summary Judgment is the procedure in civil cases where the Judge can declare a winner and a loser in the whole case without having to go the distance to a full trial. This is based on (usually voluminous) legal briefing and evidence showing that the facts are not in dispute and arguing that, therefore, the legal rules can be applied directly to those facts by the Judge, thus saving the taxpayers the massive expenses of tying up a courtroom and all of its personnel for a full-blown trial. Here, the trial Judge ruled in favor of the Seller for two reasons: 1) Buyer did not legally exist at the time the contract was entered into, and; 2) Seller was justified in refusing to go forward with the sale because Buyer was not then ready, willing and able to fund the purchase. Both sound like pretty solid reasons for the Seller to win and the Buyer to lose, no?

Now it was time for the Appellate Court to take a closer look. The purchase and sale agreement, entered into in March 2004, provided for the sale of the hotel for $8.7 million by 607 South Park, LLC, as Seller, to a Buyer named Creative Environments. In February 2005, Creative Environments entered into an assignment agreement with 02 Development, LLC, purporting to assign Creative Environments' rights as Buyer in the hotel purchase contract to 02 Development, LLC. As I am mentally ready for the Super Bowl while writing this over Super Bowl weekend, an 'assignment' of a contract is the legal equivalent of a quarterback handing off the ball after the snap to a running back who then runs for a touchdown. ***But, in February 2005, when this assignment agreement was entered into, 02 Development, LLC did not then exist.*** A gentleman by the name of Epstein signed in February 2005 on behalf of 02 Development, LLC, but the 02 Development, LLC entity was not formed until several months later in May 2005, when Epstein sent in all the completed paperwork to the California Secretary of State's office and paid the fees. OK, nobody's perfect, you say. . .

The Seller called off the sale before the date for closing the sale escrow came around. When 02 Development, LLC (Buyer) then sued 607 South Park, LLC (Seller) for breach of the contract to sell the hotel, Buyer argued that Seller breached the agreement to sell the hotel by, among other things, denying that Buyer had any rights in any contract to buy the hotel and therefore refusing to go forward with the sale. Seller argued the contrary, that neither Epstein nor 02 Development (the Buyer) had either the $8.7 million needed to close the deal or a loan commitment to provide the purchase money to close the deal and buy the hotel, so, therefore, Seller was legally justified in calling off the sale early. Buyer responded that: 1) a business entity can legally enforce a 'pre-organization contract' (a contract which was entered into before the entity existed- *the metaphysical part*), and; 2) Buyer only needed to show that it could come up with the money when the contract said it was time to pay, and not a moment before; thus Seller blew the ball dead too soon (sorry, Super Bowl fever strikes even old lawyers!).

The Appellate Court first discussed the 'pre-organization contract' issue, saying that this point is 'hornbook law,' meaning that the point is so obvious that even a lowly law student should know it from his or her textbooks. 'Hornbook' is a very old name, originating back in the 15th Century, for an early primer or legal textbook. The Appellate Court noted the rule in many cases that 'pre-organization contracts' can, indeed, be enforced by the legal entity for whose benefit the contract was made, after the entity was later formed. Seller argued that an entity that does not exist cannot enforce its supposed contract rights. To this, the Appellate Court said: you are technically right, but the point is irrelevant here! Even though 02 Development, LLC did not legally exist when Epstein assigned it the contract rights as Buyer, a few months later when 02 Development, LLC was formed, this entity then was legally able to enforce those contract rights which were made for its benefit when it was a mere gleam in Epstein's eye and not yet legally in existence (not unlike presents given to a newborn baby at a baby shower before the baby has been born). Seller, not to be outdone, then argued that, when 02 Development, LLC did finally come into existence, it never thereafter ratified (meaning, *approved of*) the contract that was created months before its birth, supposedly for its benefit. The Appellate Court countered that, *because Seller left this argument out of its briefing papers before the trial court*, Seller could not now make this argument for the first time to the Appellate Court. The Appellate Court further suggested that this lack of evidence of ratification, or later approval, actually might have been a winning argument for Seller to keep its trial court victory on appeal. The Appellate Court's disposition of this issue does not really discuss the metaphysical question of exactly how one goes about enforcing a contract made by an entity which did not exist at the time. In keeping with our Super Bowl theme, you could say the Appellate Court did not squarely face this issue; they 'punted.'

Next, the Appellate Court considered the second argument (which it called the 'causation' argument) - that Buyer did not have the money to close the deal, so Seller was perfectly within its rights to repudiate the deal early (what lawyers call an Anticipatory Breach of the contract - *a breach done in advance* of when the actual performance under the contract was required). This issue should be decided based on who had the burden of proof, another way of saying: whose job it was to first prove this point. Here, Seller argued that it was Buyer who had the job to first prove that Buyer either had the $8.7 million in hand or that it had a commitment from a lender to lend Buyer the money to close the deal. Remember, it was Seller who was the moving party on the Summary Judgment motion. The Appellate

Court said that No-- it was Seller, as moving party seeking Summary Judgment, (not Buyer!) who actually had the burden of proof (Seller first had to prove) that Buyer did not have some other way to get the money other than either having the funds in hand or having a commitment from a lender for a loan of the funds. Further, the Appellate Court said that Seller should not have refused to perform the purchase and sale contract to sell the hotel to Buyer without first giving Buyer a chance to come up with the $8.7 million to buy the hotel. Because Seller had what was sometimes called 'a happy trigger finger' back in days of the Old West, Seller had pulled the trigger too soon by calling off the sale before time for closing had come, therefore, Seller was wrong in never giving Buyer a chance to come up with the money to close the deal.

Therefore, the Appellate Court said, it was ***not*** Buyer's job to first prove for the Summary Judgment motion that Buyer could come up with the purchase money to buy the hotel. That burden (of proof) never shifted away from being the Seller's original burden as moving party on its motion for Summary Judgment—in other words, it was always Seller's job first to prove that Buyer: 1) did not have the purchase money, and; 2) did not have a loan commitment, and; 3) ***that Buyer had no other conceivable way to get the money!*** Perhaps the Buyer had a rich uncle, or hit the lottery, or was expecting the money to fall from a passing airplane (like D.B. Cooper!) The Appellate Court finally said that the trial court was wrong to have granted Summary Judgment in favor of the Seller for these two reasons, reversing the judgment in favor of Seller, and sending the case back to the trial court for trial. The Buyer had to be given the opportunity to perform up until the time escrow was to close; ***Seller cancelled too soon***. Lastly, the eternal, final question: ***what have we learned here***? - reversing the Summary Judgment means that the Seller and Buyer will now have to incur all the expense, delays and attendant stresses involved in taking this case to and through a full trial, having lost their opportunity to avoid trial through the streamlined Summary Judgment process, *i.e.,* if Seller had waited until after the scheduled time for close of escrow to may have prevailed, Seller may have prevailed.

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