

Stuart Kane LLP

The “Best Efforts” Standard in California: Still a Rolling Stone (and What to Do About It)

You just inked the \$40 million sale of your company's mixed-use commercial building. The arduous negotiations involved tenant estoppels, entitlements, and complex environmental issues. Both parties have 1031 exchanges driving tight deadlines.

Murphy's Law applies, so a title problem with a parking easement threatens to derail the deal. The cure: a side-letter agreement. The seller (your company) promises in writing to use “best efforts” to obtain a signed easement deed from the third party whose interest appears to be clouding title. Also, \$400,000 of the purchase price will be held back in escrow, to be released when both parties agree that the seller has satisfied its best-efforts obligation, or in nine months, whichever occurs first.

Anxious to get that \$400,000 released before the 1031 exchange deadline, you call the third party whose interest is arguably clouding title. They: (1) ask why you are calling instead of the current owner (i.e., the buyer); and (2) tell you to pay them \$250,000 or pound sand. You contact their attorney, and hear the same thing. You assert to the buyer that you have made your “best efforts,” and demand release of the \$400,000 escrow holdback.

But the buyer, still unable to obtain title insurance for the parking easement, won't release the holdback funds (shocking), and demands that you sue the third party for declaratory relief and to quiet title. Your mind flashes with the vision of throwing giant piles of green cash into your Vitamix. And lawsuits are not decided in nine months anyways.

So, in California, what does “best efforts” require? Has the company satisfied its obligation to the buyer, or is more required? At the drafting stage, if adding detailed and precise language about the company's duties was not feasible, then using the phrase “commercially reasonable efforts” instead of “best efforts” would have provided somewhat greater protection. But if stuck with trying to meet a “best efforts” requirement, the company should at least find ways to demonstrate that it has acted reasonably and in good faith.

The California Legislature Appears to Equate “Best Efforts” and “Good Faith”

Although the California legislature has never directly defined the phrase “best efforts,” some guidance can be found in statute. Notes by commentators on section 2306 of the California Commercial Code (dealing with certain types of contracts) apply a “good faith” standard to “best efforts.” (See Comment No. 1 to the California Code Comments, and 5 to the Universal Commercial Code Comment to section 2306.)

Case Law: No Set Definition of “Best Efforts”

No California case law provides a precise definition and the California Supreme Court has not weighed in. Thus, the standard may vary from district to district, although published cases from any district can apply throughout the state. The Court of Appeal governing Orange County courts has decided that it depends upon the circumstances and is a “factual issue.” (*US Ecology, Inc. v. State of California* (2001) 92 Cal.App.4th 113, 136.)

More-specific guidance comes from other California appellate districts, including the importance of considering what was said during negotiations and the parties' pre-dispute conduct, and also equating “best efforts” and “good faith,” as well as “reasonableness.” As explained in *Baldwin v. Kubetz*: “In this, as in every contract, there is the implied covenant of good faith and fair dealing; that neither party will do anything that would result in injuring or destroying the right of the other to enjoy the fruits of the agreement. [Citations.] The law will therefore imply that under its agreement appellant was obligated in *good faith* and by its *reasonable and best efforts*...” (*Baldwin v. Kubetz* (1957) 148 Cal.App.2d 937, 943 [emphasis added], citing *Brawley v. Crosby Research Foundation* (1946) 73 Cal.App.2d 103, 112, quoted in *Security Mut. Cas. Co. v. Transport Indem. Co.* (1977) 66 Cal.App.3d 1009, 1018, and *Brogdex Co. v. Walcott* (1954) 123 Cal.App.2d 575, 581.)

The Third District Court of Appeal (Sacramento area) has provided the most in-depth treatment, having collected decisions from outside California to reach the conclusion that making “best efforts” requires a party to “use the diligence of a reasonable person under comparable circumstances” but not “every conceivable effort.” (*California Pines Property Owners Assn. v. Pedotti* (2012) 206 Cal.App.4th 384, 394-95 [Pedotti].)

Of course, “best efforts” excludes conduct thwarting or competing with the other party. But as explained in *Pedotti*, it does not mean “every conceivable effort,” nor

does it require the promising party to “ignore its own interests, spend itself into bankruptcy, or incur substantial losses to perform its contractual obligations.” It does require “the diligence of a reasonable person under comparable circumstances, within the bounds of reasonableness” that are “reasonable in light of that party's ability and the means at its disposal and of the other party's justifiable expectations” and “does not create an obligation equivalent to a fiduciary duty.” (*Pedotti* at pp. 394-95.)

Although it too has no settled or universally accepted definition, drafters usually prefer the alternative of “commercially reasonable efforts” to “best efforts.” At least it is well-settled in California that “commercially reasonable efforts” permits the performing party to consider its own economic business interests (*see, e.g., Citri-Lite Co. v. Cott Beverages, Inc.* (E.D. Cal. 2010) 721 F.Supp.2d 912, 926), whereas that is not the clear or universal standard for “best efforts.”

How to Respond to That Demanding Buyer

Here, with a drop-dead date of nine months for release of the \$400,000 escrow holdback, the parties clearly did not contemplate prolonged litigation with a third party. Thus, under any reasonable interpretation of “best efforts,” filing a lawsuit is not likely required. But communicating with the buyer about the efforts that have been made, requesting suggestions, and proposing joint efforts could demonstrate performance, or help avoid a dispute.

Attempting to negotiate the \$250,000 demand from the third party, and going back to the buyer to discuss who would pay the negotiated settlement, is a reasonable expectation. Requesting mediation would also help demonstrate both “good faith” and “reasonableness.”

When drafting the agreement in the first place, the best practice is to define the parties' duties carefully, in detail. But sometimes, keeping the requirements vague and avoiding prolonged negotiations may be necessary—particularly when time or economic pressures weigh heavily against any chance of killing the deal. Nonetheless, using “commercially reasonable efforts,” rather than “best efforts,” is recommended if possible, to at least assure that the company can consider and protect its own economic business interests in the course of performing its obligations.

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