Liquidated Damages and Deposit Forfeitures

Introduction

Real estate transactions sometimes fail; that's a fact of life. When they do, the parties face the potentially bewildering task of figuring out who might be at fault and whether either has recourse against the other. The resolution of contract disputes can be quite complex.

Liquidated damages clauses can eliminate some of this complexity. When made a part of a real property purchase contract, a liquidated damages clause enables a buyer and seller to agree up front, before problems arise, the amount of monetary damages a party will be entitled to in the event the other party fails to perform properly (i.e., if the other party "breaches" or "defaults on" the contract).

While liquidated damages clauses can be used in many different ways, this legal memorandum only addresses clauses liquidating damages to a seller in the event of a buyer's breach of a real property purchase contract—the most common type of liquidated damages clause used in the real estate industry. Liquidated damages clauses liquidating damages to a buyer in the event of a seller's breach, in leases, or in other types of contracts may be subject to different rules, and generally should not be used without first consulting with an attorney.

Q 1. *What does the typical liquidated damages clause in a real property purchase contract say?*

A Liquidated damages clauses in real property purchase contracts can be drafted in a wide variety of ways. However, most such clauses provide that, if the buyer fails to complete the purchase as a result of his or her default, the seller is entitled to the buyer's deposit as compensation for the buyer's breach. While a liquidated damages clause can, in many cases, identify an amount of money other than the buyer's deposit as liquidated damages, the buyer's deposit is the most commonly used benchmark.

Q 2. *Must a liquidated damages clause comply with any special legal requirements to be deemed enforceable?*

A Yes. A liquidated damages clause liquidating damages to a seller in the event of a buyer's breach of a real property purchase contract is presumptively valid if:

- The amount of money identified as liquidated damages is not excessive (see Question 3); and
- The clause satisfies certain formatting requirements (see Question 4). [1]

Contracts for the sale of subdivision interests regulated by California's Subdivided Lands Act (generally new subdivisions of five or more parcels) must comply with certain additional requirements, as discussed below.

Q 3. *Are there any limits on how much money a seller can safely collect from a buyer as liquidated damages?*

A To be deemed valid, a liquidated damages clause in a real property purchase contract liquidating damages to a seller should reflect a "reasonable estimate" of the actual loss that the seller would suffer in the event of a buyer's breach. [2] While the "reasonableness" of a liquidated damages clause depends on many factors, the basic objective of the law is that sellers not use liquidated damages clauses to "punish" buyers unfairly, or to make a large profit over and above their actual financial injury.

An additional, more specific, rule applies if the real property being sold is a dwelling containing not more than four residential units, one of which the buyer intends, at the time the purchase contract is made, to occupy as a principal residence. In these types of transactions, a liquidated damages clause identifying all or part of a buyer's deposit as liquidated damages will be presumed reasonable if the amount actually paid pursuant to the clause does not exceed more than 3% of the property's selling price. A party challenging the validity of such a clause (typically the buyer) would have the burden of proving that the amount identified is unreasonable. Conversely, if the amount actually paid exceeds 3% of the selling price, the liquidated damages clause is presumed to be unreasonable, and the party seeking the damages (typically the seller) might have to prove that the amount identified is reasonable.[3]

Parties to residential real property purchase contracts usually should not agree to a liquidated damages clause that identifies more than 3%of the selling price as liquidated damages without discussing the matter with an attorney. For this reason, liquidated damages clauses in many preprinted real property purchase contracts, including those published by C.A.R., automatically limit liquidated damages to 3% of a residential property's selling price, to prevent buyers and sellers from inadvertently agreeing to a potentially excessive amount of liquidated damages.

For sales of subdivision interests regulated by California's Subdivided Lands Act, the law specifically limits the liquidated damages a subdivider can collect from a defaulting buyer to the amount of purchase money advanced by the buyer toward the purchase of the property.[4]

Q 4. *Does a liquidated damages clause have to be in any special format?*

A To be deemed valid, a liquidated damages clause in a real property purchase contract liquidating damages to a seller should conform to the following formatting requirements:

- If the contract is preprinted, the clause must be in at least 10-point bold type, or contrasting red print in at least 8-point bold type.
- The clause must be separately signed by each party to the contract. [5]

Liquidated damages clauses in C.A.R.'s purchase agreements conform to all applicable formatting requirements.

Q 5. *What is the potential benefit of a liquidated damages clause in a real property purchase contract?*

A A liquidated damages clause provides a buyer and seller with a degree of certainty; they know at the beginning of their transaction the amount of money the buyer might forfeit, and the amount the seller might recover, in the event the buyer breaches the contract. Fixing the amount of the seller's

recovery in advance may make it easier to resolve subsequent disputes between the buyer and the seller.

Q 6. ***Given the benefits of liquidated damages clauses, shouldn't buyers and sellers always insist on one?***

A Not necessarily. A liquidated damages clause is an estimate of the damages a seller might be entitled to in the event a buyer were to breach a contract. This estimate could differ significantly from the actual damages ultimately suffered by a seller.

For example, assume that a buyer's deposit was $5,000, but the actual financial loss to the seller when that buyer wrongfully failed to perform ended up being $7,000. In this case, a liquidated damages clause fixing the seller's recovery at $5,000 would probably preclude the seller from recovering the additional $2,000 of damages. Here, the seller might regret having agreed to liquidated damages. On the other hand, assume that the actual financial loss to the seller ended up being only $4,000. In this case, a liquidated damages clause could result in the buyer forfeiting more than the seller's actual damages, and the buyer might regret having agreed to liquidated damages.

Q 7. ***Should a REALTOR® advise a client whether or not to agree to a liquidated damages clause?***

A No. As illustrated in the previous question, the decision to agree or not agree to a liquidated damages clause may depend on a combination of legal and economic factors, along with a client's own personal concerns. Though many REALTORS®' clients decide to agree to liquidated damages clauses, a client with serious questions regarding such a clause should consider discussing the matter with an attorney if needed.

Q 8. ***Does a liquidated damages clause automatically entitle the seller to the buyer's deposit if a transaction does not close?***

A No. As already stated, a liquidated damages clause only determines the amount of money a seller can recover from a buyer, and then only if the seller can prove that the buyer breached the contract. A buyer may fail to close a transaction for a variety of acceptable reasons (e.g., where the buyer's obligation to purchase was contingent on the buyer obtaining financing, and the buyer could not reasonably obtain financing). To recover liquidated damages, the seller generally must prove in court or arbitration that the buyer's failure to close the transaction was wrongful.

A limited exception exists for certain sales of subdivision interests regulated by California's Subdivided Lands Act. A subdivider's contract may include a procedure whereby an escrow holder is authorized to release a buyer's deposit to the subdivider pursuant to a liquidated damages clause if the subdivider provides a specified notice to the escrow holder and buyer declaring the buyer to be in default, and the buyer does not object to the subdivider's notice.[6]

Q 9. ***If a buyer and seller disagree as to whether the buyer breached a contract, can the seller refuse to release the buyer's funds being held in escrow?***

A Generally, a prudent seller will instruct an escrow holder not to release escrowed funds to a buyer only if he or she has a good faith belief that the buyer breached the contract. Without such good faith belief, the seller runs the risk that the buyer will institute a lawsuit or arbitration, not just to recover the escrowed funds, but also to recover penalties or damages from the seller.

If the subject property is real property containing one to four residential units, one of which, at the time the escrow was created, the buyer intended to occupy, an additional, more specific rule applies. This rule provides that, unless the seller is withholding the buyer's funds pursuant to a good faith dispute with the buyer, the seller's failure to authorize the release of the funds within 30 days following a written demand from the buyer may subject the seller to a penalty equal to three times the amount of the undisputed funds (but not less than $100 nor more than $1,000), in addition to reasonable attorney's fees. A "good faith dispute" is defined, in part, as a reasonable belief of one's legal entitlement to withhold the escrowed funds.[7]

If the property is part of a subdivision regulated by California's Subdivided Lands Act and the escrow does not close on or before the mutually agreed closing date, any portion of the buyer's deposit(s) not being claimed as liquidated damages by the subdivider must be returned to the buyer within 15 days after the agreed closing date. This obligation must be stated specifically in the subdivider's contract.[8]

Q 10. ***If a buyer and seller disagree as to whether the buyer breached a contract, can an escrow holder honor a buyer's request to release his or her funds?***

A Once a buyer and seller have properly executed escrow instructions to an escrow holder, the escrow holder generally will not release funds to a buyer over a seller's objection unless so ordered pursuant to litigation or arbitration proceedings.

Q 11. ***Could a seller collect monetary damages from a buyer for breaching a real property purchase contract that did not contain a liquidated damages clause?***

A Yes. The fact that a real property purchase contract does not contain a liquidated damages clause does not mean that a buyer could escape liability for failing to perform. It simply means that the amount of damages the seller could recover would not have been pre-negotiated, and therefore the seller might have to prove, in court or arbitration, the amount of his or her actual monetary injury. Establishing the financial loss resulting from a breach of contract can be a complex process, and may require the presentation of evidence in court or arbitration. Generally, a seller will need the assistance of an attorney to properly calculate the actual damages he or she has sustained in a failed real estate transaction.

Q 12. ***If a buyer and seller agree to a liquidated damages clause, are the seller's remedies limited to pursuing liquidated damages, or could the seller pursue other legal remedies, such as specific performance?***

A Monetary damages represent only one type of legal remedy available to a seller. There are other types of legal remedies that a seller can pursue when a buyer breaches a contract, including specific performance (a type of legal action to compel a party to a contract to complete his or her performance under the contract). Typically, a liquidated damages clause only limits the amount of

monetary damages a seller can collect as compensation for a buyer's breach of contract; it does not by itself prevent the seller from pursuing an action for specific performance.[9]

For sales of subdivision interests regulated by California's Subdivided Lands Act, the California Department of Real Estate (DRE) publishes a sample liquidated damages clause which includes language limiting the subdivider's remedies to liquidated damages.[10] Because the DRE enforces the Subdivided Lands Act, the provisions of its sample liquidated damages clause may provide subdividers with guidance in drafting enforceable liquidated damages clauses.

Q 13. ***The previous question suggests that sellers can often choose from amongst various legal remedies when a buyer defaults. Which is the best legal remedy?***

A Choosing an appropriate legal remedy usually depends on many different factors, including the extent of one's injury, the complexity of pursuing a particular remedy, and potential legal costs. For example, an action for specific performance, to compel a buyer to complete his or her contractual obligations, is generally much more complex than an action to recover liquidated damages, may be more difficult to win, and may be more costly than an action to recover liquidated damages. A seller who is interested in exploring the benefits and detriments associated with different legal remedies generally should consult an attorney.

Q 14. ***If a buyer makes more than one deposit pursuant to a purchase contract, will a liquidated damages clause entitle a seller to all of the buyer's deposits if the buyer defaults?***

A Not necessarily. If the real property being sold is a dwelling containing not more than four residential units, one of which the buyer intends, at the time the purchase contract is made, to occupy as a principal residence, each payment that is to constitute liquidated damages to the seller must be supported by a separately signed or initialed, properly formatted liquidated damages clause. In addition, the total of all such deposits would be used in determining whether the clause exceeds the "3% presumption" discussed in Question 3.[11] In limited cases, an increased deposit may be available to a seller as liquidated damages despite the failure of the parties to execute a separate liquidated damages clause, but generally only where there is other evidence that the parties were aware that the increased deposit would be subject to a liquidated damages clause.[12]

C.A.R. publishes Receipt for Increased Deposit/Liquidated Damages (C.A.R. Form RID), which allows the parties to a real property purchase contract to agree to multiple liquidated damages clauses covering multiple deposits.

Q 15. ***What would happen if fewer than all parties initialed a liquidated damages clause?***

A Because liquidated damages clauses are optional, it is important that contracting parties clearly indicate in their contract whether or not they intend to be bound by a liquidated damages clause. If some, but not all, parties initial a liquidated damages clause, it can be difficult to determine whether they intended to be bound by the clause, or whether they intended to enter into a contract at all. Some purchase contracts attempt to prevent such ambiguities by specifically stating that the contract is not binding until all parties reach agreement to initial or not initial the liquidated damages clause. C.A.R.'s purchase agreements typically include language to this effect.

In the absence of such contractual language, the enforceability of the clause would be subject to interpretation by the courts. In one case, a California appellate court ruled that a liquidated damages

clause, though not properly executed, was enforceable or voidable at the buyer's option, but not the seller's option.[13] Various factors can affect the outcome of lawsuits, making it possible for different courts to reach different conclusions on similar facts. For this reason, contracting parties generally should not rely on court opinions as justification for leaving ambiguities in a contract.

Q 16. ***Is a "nonrefundable deposit" clause the same as a liquidated damages clause?***

A No. A nonrefundable deposit clause typically provides that the buyer must forfeit his or her deposit to the seller even if the buyer has a valid reason for not closing the transaction. By comparison, a liquidated damages clause entitles a seller to the buyer's deposit only if the buyer breaches the contract (see Question 8). It can be difficult to draft an enforceable nonrefundable deposit clause; only an attorney should attempt this.

Q 17. ***Where can I obtain additional information about this subject?***

A This legal article is just one of the many legal publications and services offered by C.A.R. to its members. For a complete listing of C.A.R.'s legal products and services, please visit car.org.

Readers who require specific advice should consult an attorney. C.A.R. members requiring legal assistance may contact C.A.R.'s Member Legal Hotline at (213) 739-8282, Monday through Friday, 9 a.m. to 6 p.m. and Saturday, 10 a.m. to 2 p.m. C.A.R. members who are broker-owners, office managers, or Designated REALTORS® may contact the Member Legal Hotline at (213) 739-8350 to receive expedited service. Members may also submit online requests to speak with an attorney on the Member Legal Hotline by going to http://www.car.org/legal/legal-hotline-access/. Written correspondence should be addressed to:

CALIFORNIA ASSOCIATION OF REALTORS®
Member Legal Services
525 South Virgil Avenue
Los Angeles, CA 90020

The information contained herein is believed accurate as of May 2, 2003. It is intended to provide general answers to general questions and is not intended as a substitute for individual legal advice. Advice in specific situations may differ depending upon a wide variety of factors. Therefore, readers with specific legal questions should seek the advice of an attorney.

Endnotes

[1] Cal. Civ. Code § 1676.
[2] Cal. Civ. Code §§ 1671(b), 1676, 3275. Also see *Ridgley v. Topa Thrift and Loan Ass'n*, 17 Cal. 4th 970 (1998).
[3] Cal. Civ. Code § 1675.

[4] 10 Cal. Code Regs. §§ 2971(a), (c)(1).
[5] Cal. Civ. Code §§ 1676, 1677.
[6] 10 Cal. Code Regs. § 2971(c)(4).
[7] Cal. Civ. Code § 1057.3.
[8] 10 Cal. Code Regs. § 2971(a).
[9] Cal. Civ. Code § 1680.
[10] Subdivision Public Report Application Guide, California Department of Real Estate, Aug. 2002.
[11] Cal. Civ. Code § 1678.
[12] *Allen v. Smith*, 94 Cal. App. 4th 1270 (2002).
[13] *Guthman v. Moss*, 150 Cal. App. 3d 501 (1984). Also see *Allen v. Smith*, n. 12.