

# The Nonrefundable Deposit—Not!

BY SEAN E. PONIST

**I**n many real estate transactions, the seller requires the buyer to pay earnest money in the form of a nonrefundable deposit. Indeed, this procedure is often the best way for a buyer to communicate to the seller that he or she really means business. Although such deposits have been commonplace for many years, a recent court of appeal ruling holds that in certain circumstances a nonrefundable deposit is an invalid form of liquidated damages. For that reason, the court allowed the buyer to reclaim the deposit despite clear contractual language that deemed it “nonrefundable” (*Kuish v. Smith*, 181 Cal. App. 4th 1419 (2010)). When proceeding to escrow, real estate lawyers and their clients must be prepared to face this new reality.

## RETENTION OF BUYER'S DEPOSIT

In *Kuish* the court held that the seller's retention of the buyer's deposit in a rising real estate market constituted an invalid forfeiture. In the case, the buyer entered into a

contract in early 2006 to purchase a Laguna Beach residence for \$14 million, but later unilaterally cancelled escrow. The sellers quickly bettered their lot and sold the property to another party for a tidy \$15 million. But they refused to return the initial prospective buyer's \$620,000 deposit, relying on clear language in the purchase agreement that designated the deposit as nonrefundable.

The *Kuish* court rejected that label by relying on the California Supreme Court's decision in *Freedman v. The Rector* (37 Cal. 2d 16 (1951)), which held that any contractual provision in which money or property is forfeited without regard to actual damages suffered constitutes an unenforceable penalty. The state Supreme Court explained that if the seller is allowed to retain the amount of a down payment in excess of expenses associated with a contract breach, the seller will be unduly enriched and the buyer “will suffer a penalty in excess of any damages he causes.” (*Freedman*, 37 Cal. 2d at 19–20.)

In so ruling, the court relied in part on Civil Code section 3294,

which governs the imposition of punitive damages. According to the express mandate of that section, punitive damages may not be recovered in a case “arising from contract.” Thus, although the seller of real estate may clearly recover actual damages for breach of contract (see Cal. Civ. Code § 3307), the seller cannot recover punitive damages for such claims. Accordingly, the state Supreme Court found that if the seller could retain a real estate deposit without proving actual damages, the retention of that money would constitute a “penalty” against the breaching buyer in violation of section 3294 (37 Cal. 2d at 21–22).

The *Kuish* court also noted that retention of a deposit under these circumstances would violate the rules governing liquidated damages (see Cal. Civ. Code §§ 1670–1671). Because the seller in the *Kuish* case actually received a \$1 million profit as a result of the buyer's breach, the court found that there were no damages and, for that reason, forfeiture of the deposit was inappropriate. However, the court observed that the buyer's “deposit would have been nonrefundable in a falling market to the extent defendants were able to show damages.” (*Kuish*, 181 Cal. App. 3d at 1429.)

## REAL PROPERTY DAMAGES

Civil Code section 3307 controls the recovery of general damages in a failed real estate transaction. Absent

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a contractual damages provision that provides otherwise, the statute allows a seller to recover the benefit of the bargain: the excess, if any, of the amount that would have been due the seller under the contract over the value of the property to the seller, as well as consequential damages and interest.

Sellers are thus entitled to general damages to the extent that they can establish that the contract price exceeds the value of the property, determined as of the date of the buyer's breach. (See *Askari v. R&R Land Co.*, 179 Cal. App. 3d 1101, 1106 (1986).) General damages are intended to place the seller in the position he or she would have enjoyed had the buyer not breached the purchase agreement. Accordingly, such damages cannot exceed what the injured party would have received had the contract been fully performed (Cal. Civ. Code § 3358; see also, *Lewis Jorge Const. Mgmt., Inc. v. Pomona Unified School Dist.*, 34 Cal. 4th 960, 967–968 (2004)). Thus, in a booming real estate market the seller may not sustain any “benefit of the bargain” damages (*Kuish*, 181 Cal. App. 4th at 1426, quoting 1 Cal. Real Property Remedies and Damages (CEB 2d ed., 2009) § 4.75, p. 354). Indeed, the seller may be better off by virtue of the breach because the property can be sold for a higher price.

Under section 3307 a seller may also be able to recover consequential damages—those suffered by a seller as a “natural consequence” of a buyer's breach. Such damages must be reasonable, foreseeable, and necessary to make the seller whole (*Royer v. Carter*, 37 Cal. 2d 544, 550 (1951)). The law requires that conditions giving rise to consequential damages must have actually been communicated to the breaching party, or otherwise be of such nature that the breaching party should have been aware of them. (See *Lewis Jorge Constr. Mgmt. Inc.*, 34 Cal. 4th at 968–970.) Such damages include costs and expenses incurred in the aborted sale of the property, loss of income suffered as

a result of the seller's reliance on closing the purchase agreement, and payment of additional operating expenses. (See Greenwald & Asimow, *Cal Practice Guide: Real Property* (TRG, 2009) at ¶¶ 11:120–128.)

It is important to note that even in cases where general damages are not available—because of an appreciating market, for instance—the seller may still be entitled to consequential damages. However, because the theory of consequential damages is to make the seller whole, any appreciation in value after the buyer's breach may offset the seller's recovery to avoid unjust enrichment (*Askari*, 179 Cal. App. 3d at 1101).

Interest is another component of the seller's recovery. In most real estate transactions, general damages typically are not “certain, or capable of being made certain by calculation” as of the date of the breach, so interest cannot be calculated from that date. (See Cal. Civ. Code § 3287(a).) Nonetheless, the court may award an injured seller pre-judgment interest on general damages beginning on the date the complaint is filed (*Rifkin v. Achermann*, 43 Cal. App. 4th 391, 396–397 (1996)).

Still, recovering general damages, consequential damages, and interest may be difficult. The seller must prove not only the buyer's breach but also that the seller sustained actual and consequential damages as a result of the breach. There are, however, other ways for sellers to protect themselves in the event of a breach by a buyer without having to prove damages. Two of these alternatives—liquidated damages and options to purchase—are discussed below.

## LIQUIDATED DAMAGES

Liquidated damages clauses are commonly used in commercial purchase agreements as well as in the standard residential purchase agreement drafted by the California Association of Realtors. The objective of a liquidated damages clause is to have the parties

stipulate to an estimate of damages prior to any dispute so that both will know the extent of liability in the event of a breach (*El Centro Mall, LLC v. Payless Shoesource, Inc.*, 174 Cal. App. 4th 58, 63 (2009)).

For sellers, a liquidated damages clause spares them the arduous task of having to prove actual damages. Instead of being required to introduce evidence of appraisals and other elements of damage at trial, the seller need only establish that the buyer breached the agreement.

Additionally, liquidated damages are “certain,” thereby entitling sellers to interest from the date of the breach, not just from the date of the filing of the complaint, as in the case of a general damages claim. Indeed, the court has no discretion and must award pre-judgment interest upon request, from the first day there exists both a breach and a liquidated claim. (See Cal. Civ. Code § 3287(a); *North Oakland Medical Clinic v. Rogers*, 65 Cal. App. 4th 824, 828 (1998).)

Moreover, in an appreciating market, the seller can sell the property to another buyer at a higher price and still recover liquidated damages from the defaulting buyer. (In the *Kuish* case cited above, there was no liquidated damages clause and, accordingly, no right to such damages in a rising market.)

The seller's downside is minimal, but it includes the possibility that in a depreciating market actual damages may exceed the amount stipulated as liquidated damages.

Although a liquidated damages clause may not be in the buyer's best interest, the reality is that many sellers insist on one as part of the deal. Such provisions do serve to fix the amount of a buyer's exposure in the event of a breach (thus at least the buyer knows the consequences of a breach in advance), but the stipulated amount is generally considerable, and sellers are usually able to prove their case with relative ease.

If the parties have agreed to a liquidated damages provision, it must be able to withstand attack. In general, liquidated damages clauses are valid unless an opposing party demonstrates that the fixed dollar amount was “unreasonable under the circumstances existing at the time the contract was made.” (Cal. Civ. Code § 1671(b).) In determining reasonableness, courts primarily focus on whether the amount of money in question was within the reasonable range of harm anticipated at the time the parties entered into their agreement (*Allen v. Smith*, 94 Cal. App. 4th 1270, 1278 (2002)).

Courts may also consider any of the following factors as well: the amount of liquidated damages compared to the total purchase price; the parties’ relative bargaining power; the parties’ sophistication, and whether they were represented by counsel; how long the seller committed to taking the property off the market; the parties’ anticipation that proof of actual damages would be costly or inconvenient; the difficulty of proving causation or foreseeability; and whether the liquidated damages clause is included in a form contract and thus not the product of negotiation. (See *Greenwald & Asimow* at ¶ 4:316.)

For residential purchase agreements, Civil Code section 1675(e) provides that the “reasonableness” of the liquidated damages provisions shall be determined by taking into account both the circumstances existing at the time the contract was made, as well as the price and other terms and circumstances of any subsequent sale within six months of the buyer’s default. Generally, when the liquidated damages provision does not exceed 3 percent of the purchase price, the provision is presumed reasonable and valid (Cal. Civ. Code § 1675(c)).

Validity and enforceability of a liquidated damages provision also depends on compliance with certain technical requirements. First, the

clause must be separately signed or initialed by both the buyer and the seller. Second, if it is included in a printed contract, it must be set out in either minimum 10-point bold type or minimum 8-point bold contrasting red type (Cal. Civ. Code § 1677(a) & (b)). These requirements are intended to “make it [more] likely that the parties appreciate the consequences” of such a provision (see *Allen*, 94 Cal. App. 4th at 1282–1283), and they apply regardless of the nature of the real property involved in the transaction.

### OPTIONS TO PURCHASE

An option to purchase is a unilateral contract in which the prospective buyer (the optionee) pays a specified sum to the property owner in return for an exclusive right to purchase the property within a specified time frame.

## A recent court of appeal ruling holds that in certain circumstances a nonrefundable deposit is an invalid form of liquidated damages.

If the optionee elects to purchase the property, the agreement effectively converts into a binding purchase and sale contract (*Wachovia Bank v. Lifetime Indus., Inc.*, 145 Cal. App. 4th 1039, 1049–1050 (2006)). Conversely, if the optionee does not elect to purchase the property within the term of the option, the consideration paid by the optionee is forfeited to the seller. Accordingly, commentators have noted that “options to purchase are virtually identical to a binding purchase and sale agreement with a liquidated damages” provision. (See *Greenwald & Asimow* at ¶ 8:3.)

However, important differences exist between the two, and buyers and sellers should be aware of them. For instance, to recover under a liquidated damages provision, the seller must prove that the buyer breached the agreement. In contrast, under an

option agreement, the seller has already received consideration and doesn’t have to prove anything. Moreover, there are restrictions on the validity of, and maximum amount stated in, a liquidated damages provision, whereas the consideration paid for an option agreement is entirely negotiable. Additionally, liquidated damages are usually recovered from an escrow account, requiring legal action if the breach is contested; conversely, under an option agreement, the seller has already received the consideration and therefore no legal action is required.

However, a seller should take note that using an option agreement instead of a liquidated damages provision will entail at least one considerable disadvantage. Option agreements often are recorded and thus cloud title, whereas a purchase agreement containing a liq-

uidated damages clause generally is not. (See *Greenwald & Asimow* at ¶¶ 8:156–161.)

### REMEMBER THE CONTEXT

Although there are many ways parties to a real estate transaction can fix damages in the event of a breach, never lose sight of the context in which the dispute arises. In a rising market, actual damages generally are insufficient and, according to *Kuish v. Smith*, parties cannot simply rely on a “nonrefundable” deposit as a source of recovery. However, even when real estate prices are skyrocketing, the parties can still rely on a properly structured liquidated damages clause or an option to purchase contract. Both are effective alternatives. 📌

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## The Nonrefundable Deposit—Not!

- 1 In *Kuish v. Smith* the court outlawed “nonrefundable” deposits in real estate transactions.
 

True       False
- 2 A buyer’s deposit may be nonrefundable in a falling market to the extent that the seller is able to establish actual damages.
 

True       False
- 3 A contractual provision that permits the forfeiture of money or property without regard to actual damages suffered constitutes an unenforceable penalty.
 

True       False
- 4 General damages, consequential damages, and interest are recoverable under Civil Code section 3307.
 

True       False
- 5 If the buyer breaches a purchase agreement, the seller is entitled to general damages if the contract price exceeds the value of the property.
 

True       False
- 6 To be awarded consequential damages, a seller need only show that such damages were foreseeable.
 

True       False
- 7 A court may award an injured seller prejudgment interest on general damages from the date of the buyer’s breach.
 

True       False
- 8 If the parties freely and voluntarily agree to a liquidated damages clause, the courts will always respect their agreement.
 

True       False
- 9 A liquidated damages clause lets the parties know in advance the extent of liability in the event of a breach.
 

True       False
- 10 To recover liquidated damages, a seller must first establish actual damages.
 

True       False
- 11 A liquidated damages clause is enforceable only in a declining real estate market.
 

True       False
- 12 A liquidated damages clause is valid unless an opposing party demonstrates that the clause was “unreasonable” based on all information presently known.
 

True       False
- 13 In residential transactions, a liquidated damages clause that does not exceed 3 percent of the purchase price is presumptively valid.
 

True       False
- 14 To be enforceable, a liquidated damages clause must be signed or initialed by both the buyer and the seller.
 

True       False
- 15 A liquidated damages clause must be set out in at least 12-point bold type or 14-point bold contrasting red type.
 

True       False
- 16 In a contract for an option to purchase a piece of real estate, the prospective buyer is called the optionee.
 

True       False
- 17 If the optionee does not elect to purchase the property within the time limits of the option, the consideration paid by the optionee is forfeited to the seller.
 

True       False
- 18 To recover the optionee’s consideration, the seller of the property must establish that there has been a breach of contract.
 

True       False
- 19 Under California law, consideration for an option to purchase real estate may not exceed 3 percent of the purchase price.
 

True       False
- 20 A recorded option to purchase real estate may cloud title if the transaction is not consummated.
 

True       False

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