Recovering Lost Profits In Real Estate Transactions

By Sean Ponist

The court of appeals in Greenwich S.F., LLC v. Wong (190 Cal.App.4th 739 (2010) recently addressed for the first time the issue of whether lost profits may be recovered by a real estate buyer for the seller's breach of contract.

In addressing this issue, the appellate court determined that a buyer may be entitled to lost profits when the seller backs out of deal, but warned that in order to recover lost profits, the profits sought cannot be uncertain or speculative.

Lost Profits Are Recoverable Where Seller Fails to Convey

In *Greenwich*, the seller had entered into a contract with the buyer to sell an old, dilapidated home on Greenwich Street in San Francisco for $760,000 in July of 2003. The seller was aware that the buyer was purchasing the property as a "spec home" with the intention of renovating it and selling it for a profit (i.e., that the buyer intended to "flip" it).

In late 2003, the seller advised of a purported "tax issue" and the parties agreed to delay the close of escrow. While waiting for the resolution of this issue, the buyer engaged an architect who prepared drawings for the renovation of the property. The buyer thereafter worked with the seller to obtain a permit for the renovations, which was obtained in 2005.

After the permit was approved, the seller concluded that the property was worth much more than the $760,000 previously agreed to and demanded a purchase price of $1.1 million. The buyer refused to pay the new amount and brought an action for breach of contract claiming, among other things, damages under Civil Code Section 3306 for lost profits (i.e., the amount that buyer would have profited had it been able to renovate and flip the home as hoped).

Civil Code Section 3306 provides that a buyer may recover from a seller, as damages for breach of an agreement to sell real property, compensatory damages, consequential damages and interest. Compensatory damages are calculated by taking "the difference between the price agreed to be paid and the value of the estate agreed to be conveyed at the time of the breach." These are commonly referred to as "benefit of the bargain" damages. Consequential damages, however, are damages reasonably foreseeable as a result of a party's breach of contract.

The court held that lost profits constituted "consequential damages" under Section 3306 and that a buyer may seek lost profits when a seller fails to convey real estate as promised.

Lost Profits Are Not Recoverable Where Uncertain or Speculative

While the *Greenwich* decision affirmed a buyer's right to seek lost profits, it cautioned that no such recovery is allowed where the damages are uncertain or speculative. The appellate court was critical of the evidence presented by the buyer in support of lost profits. While the buyer had presented evidence of approved plans and permits, the appellate court found that the "existence of plans for a development does not supply substantial evidence that the development is reasonably certain to be built, much less that it is reasonably certain to produce profits" and discounted the evidence. Similarly, while the buyer had presented evidence of the cost of repair, the court was critical of that evidence as it was not based on the design plans but rather based on generic cost per square foot numbers without regard to the actual planned construction.

Additionally, the appellate court noted that neither the buyer (an LLC) nor its managing member "were established businesses or had track records of successfully developing or redeveloping properties." Further, while the managing member had been involved with three prior redevelopment projects, he acted as a contractor and not as part of the "development team" on those projects. Worse yet, only one of those three prior projects was profitable. Accordingly, finding that lost profits were too uncertain and speculative, the appellate court held that lost profits were not recoverable.

Recovery of Lost Profits by Flippers

So, when would lost profits be recoverable for a seller's breach? In the context of flipping, lost profits will be recoverable only in the rarest of situations. Flipping is inherently speculative and akin to establishing a new business at a new location. The general rule is that a new or unestablished business is not entitled to lost profits because its operations are too uncertain and speculative. This has been held to be true even where a franchisee of an established business seeks to establish operations at a new location. (See *Parlour Enterprises, Inc. v. Kirin Group, Inc.* (2007) 152 Cal.App.4th 281.) Thus, even an investor with an established record of buying and selling properties profitably will still have to contend with the argument that the subject property, because it is at a "new location," should therefore be treated as a "new operation," regardless of the investor's history of successfully flipping properties.

Accordingly, in order to stand any real chance of recovering lost profits, a buyer, at a minimum, must be able to establish that the seller knew or should have known that the buyer intended to resell the property for profit. Further, the buyer needs to be able to establish a proven track record of profitably flipping properties. Additionally, the buyer would need to present substantial evidence of the profit that would have been realized but for seller's breach. As stated by the *Greenwich* court, this would be the gross amount that the buyer would have received had the contract been performed, subtracted by the costs that would have been incurred. Thus, a buyer would need to show the increase in property value after renovations minus the costs of the renovations based on final plans, financing costs and construction loan costs as well as other costs associated with the acquisition, renovation and resale of the property.

Recovery of Lost Profits by Buy-and-Hold Investors

In the context of a more typical commercial real estate investment — one involving the purchase of a leased property where the profits are primarily earned from rents — lost profits should be easier to establish. Here, the profitability of the property is much easier to establish — the rents are known, the costs are known and, for that very property, there is an established income history. Nonetheless, any party seeking lost rental profits must overcome an older decision, *Stevens Group Fund IV v. Sobrato Dev. Co.,* No. 810. (1 Cal.App.4th 886 (1991).

In *Stevens*, the appellate court held that lost rents were not properly an item of consequential damages as the buyer's experts had utilized rents as part of their determination of market value. Hence, the court concluded that to award the market value as well as lost rents would have permitted a double recovery. Subsequent decisions have interpreted the decision as precluding lost rents altogether but, as pointed out in the *Greenwich* decision, *Stevens* "did not hold that lost profits — from rents or otherwise — were not recoverable as consequential damages," but merely held that they were not recoverable under the facts of that case.

The *Greenwich* court, however, should have gone further as the *Stevens* decision was wrongly decided. Just because rents had been used to determine market value does not mean that the resulting determination of market value reflects lost rental profits. While the capitalized income and comparable sale approaches employed by the buyer's experts in *Stevens* to determine market value considered rent, those approaches were used merely as a check to the cost approach, which does not consider rent and did not take into account lost rental profits.

Real estate investors typically invest to profit from both the purchase of real estate as well as from their ownership of the property and the rents collected during that ownership. Should the seller fail to convey the property as agreed, the investor should be entitled to recover all damages caused thereby, including lost rents.

Conclusion

The *Greenwich* decision has opened the door to the recovery of lost profits, but just slightly. Aggrieved investors should seek lost profits, but need to be mindful that courts are still skeptical of lost profits damages and will not allow them where even remotely uncertain or speculative.

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