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Without the benefit of a valid liquidated damages clause, the seller may retain the deposit only to the extent that actual damages were incurred according to Civil Code section 3307.

Non-Refundable Escrow Deposits

THIS ISSUE

When is a deposit to escrow in a residential real property transaction non-refundable? In early February, the Fourth Appellate District Court weighed in on this subject.[1]

BACKGROUND

The standard form of residential purchase contract used in California by most real estate professionals contains a liquidated damage provision that, when acknowledged by both parties, creates certain legal rights with regard to the retention of funds placed into escrow in the event of a buyer's breach of the purchase agreement. These forms, drafted by professional real estate publishers – CAR® and PRDS®, to name a couple – attempt to track or respond to legislative changes and case law in California. And for the most part, the forms do a good job of protecting the interests of all parties to the transaction.

But when the parties to a real estate purchase deviate from these standard forms – either by drafting changes to the forms, or drafting entirely different contracts altogether, there are inherent risks that arise during the process. Such was the case in January 2006 when Bradford Kuish agreed to buy William and Rhonda Smith's Laguna Beach residence for $14 million. The contract consisted of an offer to purchase and nine counteroffers that in many ways materially changed some of the provisions of the agreement.

There was no liquidated damages provision in the agreement. Rather, they agreed that the buyer would make a non-refundable $820,000 deposit into escrow (later reduced to $620,000). The buyer made the deposit into escrow, and began inspecting the home, which took longer than expected, requiring the escrow to be held open for nine months.

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[1] *Kuish v. Smith* (2010) 2010 Cal. App. LEXIS 165

Predictably – because these stories are not as interesting without conflict – the buyer decided not to purchase the home and demanded return of his non-refundable deposit from the escrow company. The sellers agreed to cancel the contract. And because the escrow had been open for nine months in a rising market, the sellers were able to promptly sell the property to a backup offeror for $15 million, one million more than had been offered by Kuish.

Also predictably – because what good story of conflict isn't made better by apparent greed – the sellers refused to return the $620,000 to the buyer, insisting that they could keep the non-refundable deposit (as agreed in the contract) as well as the additional million dollars they received from the backup buyer. (Without explanation, the published decision says that $400,000 of the deposit was released from escrow to the sellers, but the remaining $220,000 was retained in escrow.)

Needless to say, the buyer disagreed that the seller was entitled to the $620,000 deposit in spite of the non-refundable language of their agreement. The buyer sued to recover the money, and the sellers defended, claiming that (1) the contract was clear that the parties agreed the deposit was non-refundable, and (2) the parties had agreed that $600,000 of the deposit was consideration for the sellers' agreement to extend the date for close of escrow.

The matter was tried to a judge (no jury) who sided with the sellers, holding that the non-refundable deposit was not an illegal forfeiture, and that $600,000 of it was additional consideration for extending the date of close of escrow. The buyer was entitled to return of $20,000, but that was eaten up with prejudgment interest on the $220,000 still held in escrow.

APPELLATE DECISION

Dissatisfied with the trial court's judgment, Kuish appealed. The court of appeal reversed the trial court's judgment, finding among other things that the non-refundable deposit was an illegal forfeiture. The court of appeal began its analysis noting that the parties had not agreed to the standard liquidated damages provision in a contract. There being no liquidated damages provision in the agreement, the foundation of the appellate decision is based on the damages available pursuant to Civil Code section 3307.

Liquidated Damages Clauses

California recognizes the enforceability of a liquidated damages clause in real estate contracts. And this sounds like a great idea for sellers, given how it is written in the forms. From this language, it appears that in the event a buyer backs out of the transaction, the seller gets to keep the deposit the buyer placed into escrow – a liquidated damage. But the contract does not really say that, and if it did, it would violate California law.

The liquidated damage provision works like this: a buyer makes an initial deposit at the time of making an offer to purchase real property. At a later time, usually after removing contingencies, the buyer makes an additional deposit into escrow, customarily up to (and sometimes exceeding) three percent of the total contract value.

If both buyer and seller initial the liquidated damages provision, they are agreeing that if the buyer breaches the contract, the seller may keep the money actually deposited – the seller's *only recourse* against the buyer for breach. Thus, the seller does not need to engage in protracted litigation to prove his actual damages. He simply keeps the deposit.

But the liquidated damages provision also benefits a buyer by capping the seller's damages at the actual amount *deposited into escrow*. Thus, if the buyer breaches the contract *before* making a secondary

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deposit, the amount of the deposit may be significantly less than 3% of the purchase price. The liquidated damage is not simply three percent of the purchase price, or the total of the agreed deposits. The liquidated damage amount is the "actual money deposited," which may be less than the agreed deposits.

Still, a seller might believe he is essentially guaranteed of getting paid something in the event of a buyer's breach because this is a "liquidated damage" amount. Wrong again.

Under Civil Code section 1675, if a seller sells the property within 6 months of the buyer's breach of the original contract, the difference in price between the two transactions (plus incidental costs) is the seller's actual loss. The seller may be required to return the difference to the seller, rather than keeping the full amount deposited.

Making it simple: if the seller's actual loss when he sells the property to a different buyer is less than the deposit, the seller must return the difference to the buyer. If the property value *increases* after a buyer's breach, the seller cannot keep both the additional profit and the liquidated damage deposit.

Moreover, if the property value declines, the seller is unable to pursue the buyer for greater damages, even if he suffers losses vastly greater than the deposit amount. Thus, this is not a traditional liquidated damage clause. It is more akin to a stipulated cap on the seller's damages, where there is a fund in escrow against which the seller may make a claim for damages.

Seller's Actual Damages for Buyer Breach

Civil Code section 3307 provides: "The detriment caused by the breach of an agreement to purchase an estate in real property is deemed to be the excess, if any, of the amount which would have been due to the seller under the contract over the value of the property to him or her, consequential damages according to proof, and interest." In determining a seller's damages, "[c]onsiderations of good or bad faith are not required. The seller's main measure of damages is essentially the difference between the contract price and the property's value at the time of breach." "During a period of rising property values, when a seller seeks damages from a defaulting buyer, if the property has increased in value before trial and the seller resells the property at a price equal to or higher than the value of the contract, there are no longer any loss-of-bargain damages."

Retaining Deposit in a Rising Market

In 1951, the California Supreme Court addressed circumstances similar to the Kuish case, involving a seller who sought to retain the down payment after the buyer breached the purchase agreement in a rising market. The buyer agreed to purchase two lots owned by the seller for $18,000. The buyer paid a $2,000 down payment and agreed to pay the balance of $16,000 into escrow within 30 days. The buyer later repudiated the agreement in writing and demanded the return of his down payment. Three weeks later, the buyer wrote to the seller, stating he would take title and would pay the balance of the purchase price as soon as an easement on the property was cleared. The seller cancelled the escrow and sold the property to a third party for $20,000. The buyer thereafter asserted his willingness to purchase the property and sued the seller for specific performance. The trial court entered judgment for the seller.

The Supreme Court stated that the buyer's claims seeking either specific performance or damages for breach of contract were meritless because the buyer failed to unconditionally withdraw his repudiation of the parties' agreement until after the seller had sold the property to a third party. The Supreme Court concluded, however, that the buyer was entitled to the return of his deposit under the circumstances of the case. The Supreme Court stated: "Since [the seller] resold the property for $2,000 more than [the buyer] had agreed to pay for it, it is clear that [the seller] suffered no damage as a result of [the buyer]'s breach. If [the seller] is allowed to retain the amount of the down payment in excess of its expenses in

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connection with the contract it will be enriched and plaintiff will suffer a penalty in excess of any damages he caused."

The Deposit was NOT Non-Refundable

In the Kuish matter, it was undisputed that shortly after plaintiff cancelled escrow, defendants sold the property for $1 million more than plaintiff had agreed to pay for the property. Other than some minor incidental damages, defendants did not argue they sustained any consequential damages as a result of plaintiff's breach.

Defendants argued the agreement provided plaintiff's deposit would be "non-refundable" and, thus, they were entitled to retain the deposit. Plaintiff's deposit would have been nonrefundable in a falling market to the extent defendants were able to show damages under Civil Code section 3307. "Without the benefit of a valid liquidated damages clause, the seller may retain the deposit only to the extent that actual damages were incurred according to [Civil Code section] 3307. A deposit, however, can serve as a fund from which the seller obtains whole or partial reimbursement for actual losses. The seller must refund the excess over actual damages to the buyer, regardless of whether the breach was innocent or willful. This is true whether the buyer paid the deposit directly to the seller or into an escrow account. The deposit gives the seller the practical advantage of shifting the burden to the buyer to show that the seller's retention of the deposit constitutes unjust enrichment."

In the context of a rising market, which was the circumstance of the *Kuish* case, an interpretation of the nonrefundable term of the agreement as precluding the return of plaintiff's deposit above and beyond any damages suffered by defendants as a result of plaintiff's breach would render that provision unenforceable.

To construe the term "nonrefundable" to establish defendants' entitlement to the full deposit without regard to actual damages would essentially create a liquidated damages provision. The parties, however, expressly stipulated that the agreement did not contain a liquidated damages provision. Defendants argued the nonrefundable deposit term is not tantamount to a liquidated damages provision because the record does not show "the non-refundability of the deposits was contingent upon a breach of the purchase agreement." In any event, even if the nonrefundable deposit language of the agreement could be construed as a liquidated damages provision, the record showed that such a provision would be unenforceable because it would fail to meet the requirements of Civil Code section 1677, which requires that the provision is separately signed or initialed by each party to the contract. And if it were a liquidated damage provision, the seller would have had to refund the amount in excess of his actual losses.

No Additional Consideration

The appellate court also made short work of the sellers' argument that the $600,000 award was "additional consideration" for holding open the escrow for nine months. It found that since the non-refundable deposit was written into the original contract, it could not have been consideration for a later agreement to hold open the escrow.

CONCLUSION

The law regarding liquidated damages and illegal penalties or forfeitures is somewhat complex. Those who undertake to modify the standard form contracts regarding these complex issues certainly take risks in doing so. They are difficult for lawyers to draft, but even more so for non-lawyers.

NEXT ISSUE

Removing contingencies in a standard real property transaction.

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