What do you do When the Contract goes Breach; What Happens to the Buyer's Deposit on Cancellation

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What to Do When the Contract Goes “Breach”; What happens to the Buyer’s Deposit on Cancellation

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Most Residential Real Estate Purchase Agreements have provisions for payment of a “deposit” by the buyer into the escrow, to be credited toward the purchase price of the contract upon closing. Sometimes, even with all good intentions (and sometimes not so good), “bad things happen”, and the deal falls through. Sometimes the buyer can’t arrange financing; sometimes the buyer gets “cold feet” and just “backs out” of the deal; sometimes the seller breaches. The question that invariably arises is: “what happens to the buyer’s deposit?” Buyer wants it back; Seller wants to keep it. Meantime the Escrow officer is standing there “holding the bag.”

California Real Estate Contracts, using the standard “CAR” form carry a provision (para. 25), attempts to set forth the answer:

“25. LIQUIDATED DAMAGES: If Buyer fails to complete this purchase because of Buyer’s default, Seller shall retain, as liquidated damages, the deposit actually paid. If the Property is a dwelling with no more than four units, one of which Buyer intends to occupy, then the amount retained shall be no more than 3% of the purchase price. Any excess shall be returned to buyer. Release of funds will require mutual, signed release instructions from both Buyer and Seller, judicial decision or arbitration award. AT TIME OF INCREASED DEPOSIT BUYER AND SELLER SHALL SIGN A SEPARATE LIQUIDATED DAMAGE PROVISION FOR ANY INCREASED DEPOSIT (CAR FORM RID).”

I use the word “attempts” to set forth the answer because in reality, the clause creates more problems than it solves.

The first problem is that both buyer and seller have to “agree” and sign a joint escrow instruction to release the deposit to their agreed recipient (buyer or seller). If Buyer objects to payment to seller, or visa versa, the Escrow Agent must continue to hold the deposit until the parties resolve the dispute between themselves, or go to court for a judicial determination on the issue.

While the CAR language may look good in theory, it has some serious pitfalls when it comes to putting it to work in reality. The provision for seller to keep the deposit if the
Buyer “defaults”, is fine. But problems arise because of the triggering term, “Buyer’s default”. What does that mean? The Buyer will usually say “I didn’t default”; “It wasn’t me, judge.”

What is a Buyer “Default”. The contract provides for several “contingencies”, which must be timely exercised: “loan contingency”, “appraisal contingency”, and a number of “inspection” contingencies. The “trap” here is that these “contingencies” have time fuses running, such that if the contingency exercise date has passed, the contingency is waived. Since the contract also provides that “Time is of the essence” (para. 28) the time limits for these contingencies, and for the closing date are all “material” terms, such that missing any of these dates would be a “material breach” of the contract. Thus, if buyer misses any of the contingency dates, or the closing date, for any reason, he is in material breach, and the Seller is entitled to keep up to 3% of the purchase price from Buyer’s deposit as “liquidated damages” under the contract.

The “liquidated damages” are authorized by California Statutes, Civ. Code sec. 1675. However, the statute has some important nuances. First, the amount of the “liquidated damages” is based solely on the Buyer’s deposit actually deposited into escrow by cash or check (even a “post-dated” check would suffice). Unperformed promises to make a deposit at some future point in time would not count as a recoverable liquidated damage. Likewise, “IOUs” or some non-monetary “trade” (e.g., stocks) don’t count.

Second, the Buyer also has an opportunity to show that the “the amount is unreasonable as liquidated damages.” (CC 1675(c) Thus if the amount of the deposit, or even the 3% of the purchase price can be shown to be “unreasonably excessive”, then only some lesser “reasonable” amount may be recovered. However, the Buyer carries the burden of proof to make a showing of “unreasonableness” of the amount under subparagraph (c) of 1675.

Third, the 3% amount is deemed to be “reasonable” under the statute (Civ. Code 1675). However, the Seller has an opportunity to show that the full amount of the Escrow deposit, even over the 3% amount, should be paid as liquidated damages. However, the Seller would carry the burden of proof to show reasonableness of the full deposit amount, for this alternative to apply, under 1675(d). Hence, the Civil Code could allow the Seller to keep the entire deposit, even in excess of the 3% statutory limit, if the Seller can prove that the total deposit amount is “reasonable as liquidated damages.” (Id.) This can be accomplished if seller can show that his actual damage exceeds the 3% amount—e.g., resale price to a mitigating buyer is lower than the contract price (loss of profits and consequential damage); payments for intervening taxes, insurance, interest, and other costs, repairs and expense of upkeep of the property which the Seller would not have incurred but for the buyer’s breach (incidental damages). (Civ. Code 1675(e)(1) and (2))

Fourth, if the Buyer made a “timely” and “proper” exercise of any contingency and cancels based on that exercise, then there would be no “default”, and the full deposit must be returned to the Buyer. However, the “sticky-point” here is that the buyer’s exercise of the contingency must be both timely and proper. For example, exercise of an “inspection contingency” of the condition of the property, based on buyer’s speculation
that his future development plans might not be approved by the City Planning Dpt., would not count because the “inspection contingency” must be based on the existence of present specified “conditions of the property” (e.g., termites, structural defects, mold, history of death, or crime, and the like). Likewise, if the exercise of the purported contingency is made past the 17 day time limit, it would be invalid, and Seller will be entitled to the deposit.

The next problem arises from the language of the CAR Liquidated Damage provision itself. Both parties (Buyer and Seller) must sign a joint Escrow instruction authorizing the Escrow Officer to release the deposit proceeds to the parties designated recipient. Thus the parties must agree among themselves as to who should get the Escrow Deposit. The problem here is that in most cases of “breach” or cancellation, the parties are in some form of a “dispute” with each other, and cannot reach agreement as to who should receive the deposit funds (even the statutory 3%). It is surprising how unreasonable people get when it comes to deciding who should get the money. In that case, litigation is inevitable (either by breach of contract action, specific performance, Fraud, or Declaratory Relief).

As a concluding piece of “free legal advice” the parties finding themselves in this situation should seriously consider the cost, expense and time involved in litigation. Most Real Estate litigation cases are complex, with conflicting testimony and documents, and both sides may easily run up legal fees and costs in excess of $40,000 to $50,000, even in the most basic of disputes, double that if the case then goes to trial.

There is an attorneys’ fees recovery provision in most CAR Real Estate PSAs, but the parties won’t find out who “wins” until after the trial is over, and even then, it might be only a “partial victory” depending on the ruling of the judge. Anyone finding themselves in this situation should seriously consider whether or not there is any “cost-benefit” to pursuing the litigation course. I’m a litigator, so I would say “go for it”. But, the client is the one who will have to pay for it, so only the client can make that decision. If the other side will not be flexible enough to reach a compromise wherein both sides “share” in the deposit, then litigation may be the only alternative available.