Non-Refundable Purchase Deposits: Valid or Not?
by Dale Alberstone, Esq.

My discussion this month examines the validity of a provision in a real estate purchase contract which states that the deposit is non-refundable. As with many issues arising under real estate law, there is much to analyze before reaching any determination. The recent case of Kuish v. Smith decided by the California Court of Appeal on February 3, 2010 well illustrates the point.

The Kuish Decision

In January 2006, the buyer (Kuish) entered into a written contract to purchase from the seller (Smith), Smith's home in Laguna Beach for $14,000,000. The final agreement consisted of one offer and nine counteroffers.

It also required the buyer to make two "non-refundable" deposits into escrow in 2006. The first deposit was to be $400,000 and to be made upon the opening of escrow. That deposit was to be released to the seller upon approval of the contingencies.

The second deposit in a like amount of $400,000 was to be made on or before February 12, and escrow was to close by July 28.

Importantly, the agreement did not contain a liquidated damages provision.

Subsequently, the parties signed escrow instructions which reduced the total deposit due from the buyer to $620,000. Of that amount, $400,000 was released by the escrow company to the seller, with the remaining $220,000 held in escrow.

In September 2006, the buyer cancelled escrow and the seller promptly thereafter resold the property for $15,000,000, that is, at a $1 million profit over the contract price with Kuish. Kuish then filed suit for the return of his $620,000 deposit.

Smith defended on the basis that the deposit was expressly stated in the contract to be non-refundable, and therefore the court should enforce the agreement of the parties as written.

The trial court found that both parties were "big boys" who were sophisticated business people that understood all the ramifications of their actions and freely negotiated the deposits to be non-refundable. Because of that, the trial court held that the seller had the right to retain the deposits because the contract clearly said they were non-refundable.

What do you think? Should the seller have to refund the deposits? If so, all of the deposit amount, or just a part of it?

Before addressing those questions, let me discuss the concept of "forfeiture" under California law.

Courts Abhor Forfeitures

It has long been the policy of our California courts to look with disfavor upon forfeitures of money. As early as 1951 in Freedman v. The Rector, the California Supreme Court explained that if a seller is allowed to retain a down payment greater than his expenses in connection with a contract, he would be unjustly enriched, thereby allowing the buyer to suffer a penalty in excess of any damages he caused.

Civil Code Section 3307 provides that the general measure of damages to a seller for the refusal of a buyer to purchase a property under contract is the difference between the contract price and the property's lesser market value (if any) at the time of the breach.

Analyzing the statutory law and prior judicial precedents, the Court of Appeal in Kuish concluded that the non-refundable nature of the deposit, particularly under circumstances where the seller resold the property for a $1 million dollar profit, constituted an unenforceable penalty and forfeiture which would not be sanctioned by the court. The appellate court then concluded that the seller had to refund the entire deposit to the buyer.

Did you reach the same conclusion?

Frankly, I believe the more just result is one which would have allowed the seller to retain the entire deposit. That is because, as the lower court said, the parties were "big boys" who freely negotiated the terms of the contract. Freedom of contract should be allowed in this country, not to mention California, and if two astute businessmen negotiate a non-refundable deposit, the Court should not interfere with their agreement.

In any event, what could the seller have done to enhance the likelihood that he could retain the deposit?

Liquidated Damages

One action the seller could have taken was to provide in the contract that the deposit constituted liquidated damages. A liquidated damages clause is a provision that states that upon a buyer's breach, the seller can retain a stated sum of money as liquidated damages. As such, the seller forfeits the right to sue the buyer for any additional damages above the liquidated amount, as would have occurred in Kuish if the property decreased by a million dollars in value, rather than increased by that same amount.

With residential real property that a buyer intends to occupy (or at least occupy one of the units within the structure), Civil Code Section 1675 limits the amount of liquidated damages to 3% of the purchase price, unless the seller proves in court that a greater amount is reasonable. If the seller can satisfy the burden of reasonableness, then the stated percentage for liquidated damages may exceed 3%.

Surely the seller's attorney (or his broker) in the Kuish case, when he approved the non-

refundability language in lieu of a liquidated damage provision, had the 3% limitation in mind. No doubt the seller's lawyer (or broker) chose to denominate the deposit as "non-refundable" rather than as liquidated damages because it excluded 3%.

I surmise, however, that if the seller engaged a lawyer, that lawyer was not a real estate attorney. If he were, he would have been familiar with the problem of a non-refundable deposit as explained in the 1951 Freedman case (referenced above).

If the seller only used a broker, that licensee almost certainly never even heard of Freedman. Given the huge sale price of $14,000,000, the broker should have recommended to the seller that he engage a real estate attorney to review the contract provisions before accepting the contract.

In the case of most residential sales, whether they are apartment buildings or single-family dwellings, parties who incorporate a liquidated damages provision typically provide that any forfeited deposit is limited to 3% of the purchase price. Ordinarily, that is a wise thing to do. While courts abhor forfeiture, they typically will approve one if it is denominated as liquidated damages and limited to 3%.

Had the parties designated 3% of the deposit as liquidated damages in Kuish, the seller could have at least retained $420,000. By not being aware of the applicable law, the seller lost the right to retain any of the deposit when he denominated the whole amount as non-refundable.

Create An Option

The best way for a seller to enhance the likelihood that he will be able to retain an amount equal to a contemplated deposit is to create an option which the buyer pays for up front in lieu of making a deposit.

In a real estate context, an option is a separate contract entered into between the buyer and seller whereby the buyer pays a fixed sum of money (in the Kuish case, it would have been $800,000, or at least 620,000), in exchange for a contractual right to purchase the seller's property on specific terms set forth in a separate contract. If the buyer then elects not to purchase the property, the seller can retain the price paid for the option, not by way of penalty, but by reason of the option contract.

Of course, a buyer may not favor an option because if he later disapproves a contingency (e.g., inspection contingency or financing contingency), the purchase agreement is cancelled but the seller nevertheless retains the option money. On the other hand, if the Buyer paid the money as deposit under the purchase contract, then upon his proper cancellation, the deposit would be ordinarily refundable.

Conclusion

As you can see, there are competing interests between buyers and sellers and much to be considered with respect to non-refundable deposits. No matter how sophisticated the parties are and regardless of the clarity of their contract, the court may nevertheless void

as "unreasonable" a non-refundability provision if the judge determines that the amount of the deposit to be retained by the seller is excessive or is an unjust forfeiture.

Careful legal analysis should be given before a purchase contract is executed which designates a deposit as non-refundable, particularly where the deposit is substantial.

Dale Alberstone is a prominent litigation and transactional real estate attorney who has specialized in real property law for the past 33 years. He has been appointed to periodically serve as a judge pro tem of the Los Angeles Superior Court and is a former arbitrator for the American Arbitration Association. He also testifies as an expert witness for and against other attorneys who have been accused of legal malpractice.

Mr. Alberstone has been awarded an AV rating from Mardindale-Hubbell, which is a registered certification of Reed Elsevier Properties, Inc. An AV rating reflects an attorney who has reached the heights of professional excellence and is recognized for the highest levels of skill and integrity.

The foregoing discussion is intended as a general overview of the law and may not apply to the reader's particular case. Readers are cautioned to consult an advisor of their own selection with respect to any particular situation. Address correspondence to Dale S. Alberstone, Esq., ALBERSTONE & ALBERSTONE, 1801 Avenue of the Stars, Suite 600, Los Angeles, California 90067. Phone: (310) 277-7300.