

To Have and Have Not

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A recent California appellate court ruling found that non-refundable deposits are in fact refundable.

In a decision sure to raise a few eyebrows, the California Court of Appeal has ruled that a seller of real property must return a non-refundable deposit.

The dispute arose out of plaintiff Bradford Kuish's agreement to purchase William and Rhonda Smith's Laguna Beach home for \$14 million. In the agreement, Kuish was required to make two non-refundable deposits totaling \$620,000. He did so, although he later decided not to purchase the home. After the escrow was canceled, the Smiths accepted a backup offer and sold the property for \$15 million to a third party. The Smiths, however, refused to return Kuish's deposit, and he sued.

Despite issuing a ruling that would surprise many experienced California real estate brokers, agents and attorneys, the court found in favor of Kuish by relying on established precedent. The court ruled that a non-refundable deposit may only be retained by a seller to the extent and in the amount that the seller incurs damages as a result of the breach. Real estate brokers and agents should take care to advise their clients that in today's California, a non-refundable deposit is not really non-refundable.

The effect of the ruling is broad. It applies equally to residential and commercial real property sales. And, it applies on a going-forward basis and to past transactions. Brokers, agents and attorneys who have represented buyers in transactions where sellers retained a deposit after a buyer's breach should review the transactions to determine whether the buyers have a right to recover a deposit they thought was lost.

The appellate court analyzed the refundability issue in light of damages suffered by the seller. The seller's main measure of damage is the difference between the contract price and the property's value at the time of breach.

During a period of flat or rising property values, there are no loss-of-bargain damages where the seller sells the property to another buyer for a price equal to or greater than the value of the contract.

Relying on a 1951 California Supreme Court decision, the Court of Appeal found that allowing a seller to retain a deposit where there are no damages would result in an invalid forfeiture. The Supreme Court decision involved a seller who sought to retain a down payment after the buyer breached an agreement. In the case, the buyer agreed to purchase two lots for \$18,000. He made a down payment of \$2,000 but later repudiated the agreement and demanded return of his money. The seller canceled the escrow and sold the two lots to a third party for \$20,000. The Supreme Court concluded that because the seller "resold the property for \$2,000 more than [the original 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 connection with the contract [he] will be enriched and plaintiff will suffer a penalty in excess of any damages he caused." Although the decision did not involve the term "non-refundable," the issues were otherwise identical.

Following the Supreme Court, the appellate court in the Laguna Beach case determined that the non-refundability provision was unenforceable. It found that any provision by which money or property would be forfeited without regard to the actual damage suffered constitutes an unenforceable penalty. As such, a deposit kept by the seller after resale of the property for more than the original contract amount is a penalty absent a showing of actual damages. The court was plainly concerned that a contrary result would mean that the more money a purchaser tendered to the seller (that is, the more a purchaser had performed), the greater the penalty would be. Such a result fails to consider the degree of culpability, and its severity increases as the seriousness of the breach decreases. Thus a purchaser who breaches a contract before making a down payment or deposit would suffer no penalty, whereas one who has almost completely performed under the contract would suffer the maximum penalty.

Nor can forfeiture be justified as punishment for willful breach. The law does not generally authorize punitive damages for breach of contract, even where the breach has been willful.

Finally, the court found that to construe the term "non-refundable" to mean that the seller was entitled to the full amount without regard to actual damages would be tantamount to creating a liquidated-damages provision.

Although the Kuish parties agreed the contract did not contain a liquidated damages provision, the court discussed briefly the requirements for such a provision. The court noted that a liquidated damages provision in a contract for the sale of real property is presumptively valid if the amount of damages agreed upon is a reasonable estimate at the time the parties entered into the contract; but, a liquidated-damages provision is enforceable only where the parties, at the time they entered into the contract, would have had great difficulty determining the actual damages resulting from a future breach.

For brokers, agents and attorneys who represent parties in real estate transactions, the Court of Appeal has made clear that a non-refundable deposit is not really non-refundable. A seller who wishes to keep a down payment if the buyer breaches the contract should not use a non-refundability provision to accomplish that end. Liquidated damages may be enforceable under the proper circumstances. However, if the seller's goal is to retain a sum certain for agreeing to sell real property, an even better way to reach that goal is through an option contract. An option payment is by its very nature non-refundable, and as long as it is a true option, it will provide the most protection for a seller who wants to keep a deposit if the buyer decides not to go through with the purchase.

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