

# Legal Lines

## The Truth About Liquidated Damages

**True or false:** If a deposit receipt contains a liquidated damages clause, the seller is automatically entitled to keep the buyer's deposit on the purchase of a house if the buyer backs out of the contract for any reason. The answer: *false!* In fact, the disbursement of the buyer's deposit as liquidated damages to the seller is never automatic and the seller may not be entitled to any of the buyer's deposit, even if the buyer does not complete the purchase.

### Purpose of the Clause

The purpose of a liquidated damages clause is to establish, in advance, the amount of damages the non-breaching party to a contract will be entitled to in the event of a breach by the other party to the contract. A liquidated damages clause is not, however, a substitute for proving that the contract has been breached: it merely sets the amount of the damages *if* the contract is breached.

The determination of whether a breach of contract has occurred and, if so, by whom, is a question of fact. This type of factual question is analyzed on a case-by-case basis.

### The Court Determines the Disbursement of Funds

In the event that a transaction is not completed, the buyer's deposit should not be released to either the buyer or seller until both parties agree in writing or a court orders how the funds are to be disbursed. A court will usually order disbursement of a buyer's deposit to the seller only if the buyer is

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proven to have breached the contract.

If, for example, the buyer attempts in good faith to satisfy a condition or contingency in the contract, but cannot do so, the contract will fail. However, since the buyer attempted in good faith to meet the contingency, the buyer's inability to do so does not constitute a breach of contract. Therefore, assuming no breach of any other term of the contract by the buyer, the seller is not entitled to collect damages from the buyer, either liquidated or actual.

### Requirements for a Valid Liquidated Damages Clause

For a one- to four-unit residential property which the buyer intends to occupy, a liquidated damages clause will be valid only if *all four* of the following requirements are met:

(1) The provision must be separately signed or initialed by each party to the contract. This signature or initialing must be *in addition to* the signing of the deposit receipt. If more than one payment made by the buyer is to be covered by the liquidated damages provision, each payment must be accompanied by a separate, signed or initialed statement satisfying the

requirements set forth below. (C.A.R.'s Standard Form RID-11, Receipt for Increased Deposit and Supplement to Real Estate Purchase Contract, meets this requirement);

(2) If a preprinted contract is used, the provision must be in at least 10-point bold type or contrasting red print in at least 8-point bold type (C.A.R.'s Standard Real Estate Purchase Contract and Receipt for Deposit forms DLF-14 and D-11 meet this requirement);

(3) The provision must not be "unreasonable" under the circumstances existing at the time the contract was made;

(4) The amount to be included in the liquidated damages provision cannot exceed 3 percent of the selling price. If the amount actually paid under the liquidated damages provision exceeds 3 percent of the selling price, the provision is invalid unless the party seeking to uphold it can establish that the amount paid is reasonable. This is true whether the deposit designated as liquidated damages is made in one or several payments.

### What constitutes an "Unreasonable" Clause?

A determination of whether a particular liquidated damages clause in a particular transaction is "unreasonable" is based on: (a) the circumstances existing at the time the contract was entered into, and (b) the price, terms and circumstances of any subsequent sale or contract to sell and purchase the same property entered into within six months of the buyer's default. If a preprinted contract is used, a liquidated damages clause that is not signed or initialed is treated as though it does not appear in the form at all.