Nonrefundable option payments as liquidated damages: Allen v Smith, 2002

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*Allen v Smith, 2002*  
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Residential purchase agreement that labeled buyer’s deposit as “nonrefundable purchase option” is unenforceable as option contract.  

The Smiths accepted Allen’s offer to purchase their home for $1,775,000. The agreement contained a liquidated damages clause limiting Smith’s damages to a maximum of 3 percent of the purchase price ($53,250) if Allen failed to complete the purchase; a clause added by the Smiths’ broker required a total deposit of $100,000, “to be released to seller as a non refundable purchase option.” After Allen signed off on her contract contingencies and increased her initial $20,000 deposit with the required balance of $80,000, escrow released the entire sum to the Smiths. Allen later defaulted on the transaction and demanded return of her $80,000 deposit, claiming that the parties had not signed a separate liquidated damages provision covering the increase of deposit. The Smiths refused and Allen sued for breach of contract, alleging that the sellers’ retention of the additional deposit was an illegal penalty that circumvented the state policy of limiting liquidated damages by the “sham mechanism” of labeling deposit monies as option monies. The trial court granted the Smiths’ motion for summary judgment, enforcing the contract’s deposit provision as a “separate option agreement.”

The court of appeal reversed, holding that the contract was not an option. An option is a unilateral contract that grants an irrevocable right to purchase property at a stipulated price within a certain time; the option allows the optionee to inspect the property without meeting contingency requirements. The court found that the parties intended the agreement to be a standard, bilateral purchase and sale agreement, in which the buyer removed contingencies as a condition to proceeding with the transaction. Thus, “if inspection contingencies were unsatisfied, Allen was entitled to a return of her initial $20,000 deposit. Accordingly, the deposit cannot be considered independent consideration for an option.” 94 CA4th at 1280. Moreover, an option must specify (1) the time period within which the option must be exercised, and (2) the method of acceptance. The absence of these terms in the contract also indicated that the parties did not intend an option.

A liquidated damages provision is presumed invalid if the deposit exceeds 3 percent of the purchase price, unless the seller establishes its reasonableness. See CC §1675(d). Conceding that the agreement was a purchase and sale, the Smiths also argued that they should be able to retain the $100,000 deposit as reasonable liquidated damages. The court found that that sum bore no rational relationship to the harm that the Smiths might suffer on breach by Allen. The court remanded for entry of summary adjudication for Allen, enforcing the liquidated damages clause and awarding her damages equal to the amount in excess of 3 percent that had been retained by the Smiths.

**THE EDITOR’S TAKE:** This decision should warn real estate brokers (if they read it or if their lawyers tell them about it) that meddling with the liquidated damages clause in residential
deposit receipts can be dangerous. The contract provision that the showing broker added to the sellers’ counter-offer not only failed to accomplish its purpose, it also came very close to backfiring and letting the defaulting buyer save $33,000 from the $53,000 she should have expected to lose. This is clearly a case where the broker or one of the parties should have had an attorney do the drafting.

If the parties agree that the buyer may walk away from the deal after paying 3 percent as liquidated damages, then the printed form covers the situation and it is appropriate for the brokers merely to advise them to initial it. But if the seller wants to be able to retain twice that much on the buyer’s default, the form will no longer do, and whatever is written to replace it should be drafted with the language of the statute (CC §1675) in mind. Converting the arrangement into an option—as the broker apparently sought to do—could work, but entails doing much more than simply calling the deposit “nonrefundable purchase option money” and leaving all of the other inconsistent clauses of the document unchanged. I think most attorneys would have done a better job along those lines (although the trial judge bought the broker’s language), and they also probably would have explored other alternatives more agreeable to both parties.

At the very least, I think an attorney would have wanted to make sure that if the sellers couldn’t keep the entire $100,000 they sought, they could at least keep the $53,000 that the statutory 3-percent limit would allow, whereas the broker’s drafting could easily have led to that being reduced to only $20,000. The court of appeal very charitably interpreted the clauses as justifying $53,000, and probably saved the broker from serious liability—both for practicing law and for getting it wrong.

As a final note, I have always wondered whether the CAR provision for refunding the excess over 3 percent really works, in light of the statutory language that refers to the amount actually paid rather than to the amount retained. This opinion’s statement that the “total deposit amount is valid . . . only to the extent it does not exceed 3 percent of the purchase price” suggests that 3 percent can be kept, regardless of how much the amount of deposit actually paid exceeds that limit. Is that really so? —Roger Bernhardt