A REMINDER FROM THE FRESH PRINCE: NONREFUNDABLE DEPOSITS ARE NOT ALWAYS NONREFUNDABLE

When a real estate purchase agreement provides that a buyer's deposit is nonrefundable, one might expect the deposit to be nonrefundable under any circumstance. The California Court of Appeal has recently ruled otherwise. In commercial and residential transactions alike, it is a long standing principle of contract law that the nonrefundable character of such a deposit may depend on whether the seller actually suffered damages as a result of the buyer's breach. This principle applies even when the "nonrefundable" deposit is described as such in a properly drafted liquidated damages provision.

In *Kuish v. Smith*, the buyer executed a purchase agreement to buy a Laguna Beach property for $14,000,000 from Will Smith, Jr. (who first attained fame on the T.V. show The Fresh Prince of Bel Air). The agreement required Kuish to make two "non-refundable" deposits into escrow, but the contract did not contain a liquidated damages provision. Of the $620,000 deposit, $400,000 was released to Smith while the remaining $220,000 was held in escrow. Ultimately, Kuish backed out of the deal after failing to secure necessary approvals for his plans to develop the property. Smith then quickly sold the property to another buyer for $15,000,000 -- $1,000,000 <u>more</u> than Kuish had agreed to pay. When Kuish demanded the return of his deposit, Smith refused, and Kuish sued.

The trial court ruled that Smith's retention of the nonrefundable portion of the deposit ($600,000 of the total $620,000) did not constitute a forfeiture "because both parties were 'big boys,' that is, sophisticated business people, [who] understood all the ramifications of their actions in freely negotiating to make the deposits non-refundable." The trial court also ruled that because the length of escrow had been extended by the parties, the deposits constituted separate and additional consideration for the agreement.

The Court of Appeal unanimously reversed. The appellate court held that in a "rising market," a seller who has resold his property to a third party at a higher price is limited to the recovery of consequential damages and interest against the breaching original buyer. The appellate court relied on the 1951 California Supreme Court decision of *Freedman v. The Rector*. In that case, a buyer who made a $2,000 down payment for the purchase of two lots later repudiated the purchase agreement. The buyer was held to be entitled to recover his down payment despite his breach. The Supreme Court reasoned that because the seller had resold the property for a higher price, he had suffered no actual damage as a result of the first buyer's breach. This point is highly relevant in today's marketplace because while property values have fallen in both the residential and commercial markets, a rise in values will eventually occur as the economy moves forward again.

Now comes the part of the *Kuish v. Smith* opinion that is confusing to some people. The appellate court said:

> …the nonrefundable deposit term is not tantamount to a liquidated damages provision because the record does not show 'the non-refundability of the deposits was contingent upon a <u>breach</u> of the purchase agreement.' In any event, even if

> the nonrefundable deposit language of the agreement could be construed as a liquidated damages provision…it would be unenforceable because it would fail to meet the requirements of Civil Code section 1677, which provide…[t]he provision [must be] separately signed or initialed by each party to the contract.

Numerous commentators have misconstrued this portion of the opinion and concluded that had Smith used a liquidated damages provision, the deposit would have been nonrefundable..

Although this seems to have befuddled the blogosphere, the *Freedman* court already addressed this issue. In *Freedman*, the California Supreme Court reaffirmed a fundamental rule of contract law on liquidated damages: Even a carefully drafted liquidated damages provision may be held to be unenforceable if it "would not 'be impracticable or extremely difficult to fix the actual damages.'" Thus, when a seller quickly resells property for a higher price after a buyer's breach, that seller will likely not have suffered any loss-of-bargain damages and the position that the seller's damages had been "impracticable or extremely difficult to fix" becomes (with the use of hindsight) harder to maintain. As a result, even a well drafted liquidated damages provision could be exposed to challenge.

Another important point in the *Kuish v. Smith* opinion is the Court of Appeal's rejection of the trial court's finding that the deposit was properly retained by Smith as separate and additional consideration for the agreement to extend the escrow closing date. In rejecting the consideration-for-escrow-extension argument, the appellate court distinguished *Horowitz v. Noble*, a case in which an "irrevocably dispersed" sum of $20,000 was given in exchange for an extension of the escrow closing date. In *Horowitz*, "there was no contingency whatsoever attached to the payment of the $20,000" and the language used in the agreement was unequivocal and explicit. The payment in *Horowitz* was upheld as "consideration paid for defendants' right to extend the date of performance under the original agreement."

Our firm has long recognized the pitfalls that must be avoided with liquidated damages provisions and unqualified nonrefundable deposit terms. We have successfully employed the benefits of independent consideration payments, such as option and extension payments, as viable alternatives. The *Kuish v. Smith* opinion highlights the need to be mindful of these alternatives when structuring a deal that contains nonstandard contingencies or a long or extended escrow period.

Kuish v. Smith and our firm's recent experience also suggest that litigation has and will continue over liquidated damages provisions and nonrefundable deposits, especially because the statute of limitations to seek to recover such a deposit is generally four years. This long statutory window means that buyers may be able to "claw back" deposits even for agreements that fell apart over three years ago. This type of litigation may increase as the real estate market rebounds.