Liquidated Damages

What are liquidated damages?
A liquidated damages provision in an agreement provides for a buyer to owe a specified amount of money to a seller in the event the buyer breaches the contract. For example, if a deposit of $5,000 is placed in escrow, and the liquidated damages provision is initialed by both buyer and seller, and then the buyer breaches the contract, the seller will be entitled to the $5,000 as liquidated damages. It does not matter whether the seller has incurred an actual loss that is more or less than $5,000. The purpose of the provision is to set the amount of damages in advance so that proof of actual loss is not necessary.

Does a liquidated damages provision automatically entitle the seller to the buyer's deposit if a transaction does not close?
Generally, no. A liquidated damages provision only determines the amount of money a seller can recover from a buyer, and then only if the seller can prove the buyer breached the contract. A buyer may fail to close a transaction for a variety of acceptable reasons (e.g., where there is a financing contingency and the buyer could not reasonably obtain financing). To recover liquidated damages, the seller generally must prove in court or arbitration that the buyer's failure to close the transaction was a breach.

May the parties agree, in advance, that the buyer will pay a non-refundable deposit in the event of breach?
Generally, no. The law does not permit contracts to impose penalties or forfeitures, including a non-refundable deposit, for breach absent gross negligence or willful or fraudulent breach. Additionally, paragraph 5A(3) of the RPA-CA, specifies that any added clause specifying a remedy for a buyer breach, such as a non-refundable deposit or a forfeiture of the deposit, will be invalid unless the added clause independently complies with the Civil Code's liquidated damages rules.

If a buyer makes more than one deposit pursuant to a purchase contract, will a liquidated damages clause entitle a seller to the buyer's combined deposits if the buyer defaults?
Not necessarily. For residential 1-4 unit properties where the buyer intends to occupy at least one unit, each payment that is to be part of the liquidated damages to the seller must be separately signed or initialed in a properly formatted liquidated damages clause. In addition, if the total of all such deposits exceeds 3% of the purchase price, the seller could be limited to 3% even if more is deposited. The C.A.R. form Delivery of Increased Deposit and Liquidated Damages Addendum (C.A.R. Form DID) should be signed at the time an additional deposit is made during escrow in order to make any additional payments part of the liquidated damages.

What if the deposit is not made?
If no deposit is placed into escrow, the seller may argue that the liquidated damages clause simply does not apply and the general rule of proving damages applies instead. The buyer, however, may argue that the "amount paid" (in this case nothing) is the allowable damages pursuant to the liquidated damages clause. In such a situation both buyers and sellers should consult with their own qualified real estate attorney about how to proceed. Paragraph 5A(3) of the RPA advises both parties to seek legal advice regarding possible liability and remedies when buyer fails to make the deposit.