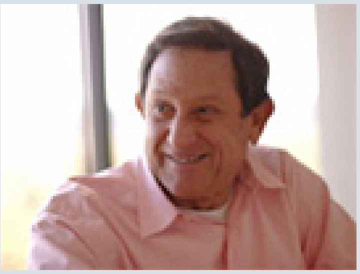
Celebrating 40 Years

Client Alert

Lessons from some recent California Appellate cases require some changes to the standard forms of real estate purchase and sale agreements in California.



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PRACTICE AREA

Real Estate

Real Estate Purchase Agreements

Two recent cases, *Steiner v. Thexton* and *Kuish v. Smith,* have brought into question again the standard operating mechanics in almost all written agreements for the purchase and sale of real property in California. Those mechanics include the notion that the buyer puts up a refundable good faith deposit upon the opening of an escrow to purchase the property and receives, in return, a period of time within which to investigate and examine its physical and legal aspects before deciding whether or not to proceed with its purchase. In the meantime, the agreement normally provides that the seller is committed to the sale (and generally must cease marketing the property) even though it will get nothing for taking the property off of the market, if the buyer elects, by the end of the due diligence period, to cancel the agreement.

The second common element is that the buyer's good faith deposit becomes non-refundable if the buyer does not cancel the agreement by the end of the due diligence period, and is payable to the seller as liquidated damages if the buyer then fails or refuses to purchase the property in breach of the agreement.

The Contingency Period “Free Look”

The *Steiner* case began its public life in the appellate courts of California in 2008, when the Court of Appeal for the Third Appellate District (extreme northeastern area of California) held that a purchase and sale agreement for real property that provided for a buyer's free look with no adverse consequences if it later cancelled within the examination period was not enforceable. The appellate court first determined that the agreement was not enforceable as a purchase contract because it lacked mutuality, since it obligated only the seller and not the buyer. The court then determined that the agreement was not enforceable as an option agreement either, because the buyer did not pay any consideration to the seller in exchange for the option to examine the property and then elect whether or not to proceed to the closing. The buyer, who spent considerable time and money during the contingency period, appealed to the California Supreme Court.

In 2010, the Supreme Court reviewed *Steiner* and agreed that the agreement was not an enforceable purchase agreement, but re-considered whether it could be enforceable as an option agreement. The Supreme Court stated that, while the agreement initially lacked any consideration because of the buyer's right to terminate without cause, the agreement became irrevocable after the buyer began to perform its promise to seek a parcel map split. This saved the agreement, and the buyer's right to purchase the property. However, it's important to note that the buyer agreed to undertake, and in fact did undertake, substantial efforts at significant cost to achieve the parcel map split. In contrast, most standard purchase and sale agreements do not obligate the buyer to perform any act to improve the property or to pay any money to the seller for its right to examine the property during the contingency period. Instead, the buyer merely allows its deposit to become non-refundable if it elects to proceed with the purchase at the end of the contingency period.

Under the reasoning of *Steiner*, unless there is some consideration given by the buyer to the seller in exchange for the buyer's right to terminate the agreement within the contingency period, now the seller, as well as the buyer, has the right to terminate the agreement during the contingency period.

Courts and scholars alike have long been concerned about the California practice of giving the buyer a free look at the property and thereby creating an “illusory” contract — one lacking consideration and mutuality. In the past, legal practitioners have attempted to limit a buyer's cancellation rights to identified, specific and reasonable objections to the property so that the right to terminate is something more than a buyer's unfettered whim or fancy. This practice according to the California Supreme Court is enough to create mutuality. Another, and I think better, way to avoid the illusory contract is to have the buyer pay something to the Seller for the unilateral right to terminate. Any amount of consideration passing from the seller to the buyer is sufficient, said the California Supreme Court. This is a common practice in a number of other jurisdictions.

The Non-Refundable Deposit

The other long-held notion among real estate practitioners has been that making a good faith deposit non-refundable at some stage in the purchase process will limit the buyer's exposure to the seller in the event of a breach of the agreement by the buyer and, from the seller's standpoint, assure it of reasonable compensation for taking the property off the market and then suffering a breach of the agreement by the buyer. However, in the recent case of *Kuish v. Smith* , the Court of Appeal for the Fourth District (San Diego and Orange Counties) ruled that a seller's retention of a non-refundable deposit after re-selling the property to another buyer for a substantially higher price, constituted an invalid forfeiture. In this case the buyer put up a $620,000 deposit against a $14 million price, but failed to complete his purchase. The seller kept the buyer's deposit and then resold the property for $15 million.

The lesson from this case is that in order for a seller to be entitled to liquidated damages there must first be some showing of damages to the seller. In a rising market, this is often very difficult. And, in any event, the requirement that the seller “prove up” his damages is counter to the concept of liquidated damages. Parties agree to liquidated damages (a set amount that will compensate the seller for the buyer's breach) in order to allow the seller to collect damages without having to prove them. Rather than having to litigate the amount of the damages, the parties instead agree that the amount of damages will be difficult to predict ahead of time and therefore set an amount that they agree is a fair and reasonable estimate of damages that will be suffered by the seller and that are a fair payment by the buyer.

Conclusion

What do these cases tell us? Taken together, the cases instruct that purchase and sale agreements should be structured as option agreements. A small initial option payment should be made to the seller, to be retained by the seller whether or not the buyer proceeds to purchase the property, in consideration of the buyer's examination of the property during a contingency period. The California Supreme Court said that any measure of consideration passing from the buyer to the seller would be sufficient to prevent the seller from attempting to terminate the agreement for a lack of consideration, so this initial option payment can be nominal.

The buyer should be obligated to increase the option payment after the last day of the contingency period if the buyer elects to purchase the property. In lieu of liquidated damages, the parties can agree that the additional option payment will be retained by the seller even if the buyer does not proceed to the closing, but will be applied to the purchase price at the closing. The seller should waive the right to make any claim for damages in excess of the option payment.

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