

Real Estate Purchase and Sale Transactions - How to Do Them Right!

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The Process Begins – Tying Up the Property

By

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A. LETTERS OF INTENT.

To avoid wasting time and money pursuing deals that eventually do not close, many buyers and sellers memorialize the most significant agreed-upon deal points in a letter of intent (LOI) before they start incurring major legal and other transaction expenses. However, clients are frequently unaware of the risk involved in using LOIs.

1. How do Letters of Intent Present a Risk?

The parol (word of mouth) evidence rule prohibits the introduction of evidence at a trial which contradicts the terms of a written contract; but does not prohibit the introduction of evidence of oral agreements between the parties if such evidence is not inconsistent with the contract or if the contract is either incomplete or silent on the subject of such oral agreements. Under traditional contract principles, extrinsic evidence is inadmissible to interpret, modify or add to the terms of an unambiguous contract. California, however, does not follow traditional contract law. Many courts have been quick to disregard the seemingly clear language contained in letters of intent in order to permit the introduction of contradictory oral evidence. An illustration of the risk posed by the parol evidence rule is vividly summarized in *Trident Center v. Connecticut General Life Insurance Company* (9th Cir. 1988) 847 F. 2d 564, in which the Ninth Circuit Court stated:

The contract documents are lengthy and detailed; they squarely address the precise issue that is a subject of this dispute; to all who read English, they appear to resolve the issue fully and conclusively. Plaintiff nevertheless argues here ... that it is entitled to introduce extrinsic evidence that the contract means something other than what it says. This case therefore presents the question whether parties in California can ever draft a contract that is proof to parol evidence. Somewhat surprisingly, the answer is no.

Consequently, parties should be aware of the risk involved in signing even the most carefully drafted LOI. Parties with leverage frequently minimize this risk by negotiating and memorializing the deal points of a contract in a LOI, having the party with the least

leverage sign the LOI first, and then moving ahead with the drafting of the agreement without executing the LOI.

2. Benefits of Letters Of Intent.

A properly drafted LOI is unambiguous, internally consistent and provides the prospective parties to a transaction with the necessary level of safety and comfort to induce them to commit the time and money necessary to negotiate, draft and review a binding agreement. LOIs are useful in compelling the parties to articulate their understanding of the proposed transaction and thus flushing out any potential misunderstandings before either party has invested significant time and money into documenting the deal. Well drafted LOIs clearly spell out the parties' agreements regarding the most important issues and thus serve as a roadmap to assist the person preparing the contract to accurately reflect the deal the parties thought they were agreeing to. A LOI can be a useful tool to get a party to commit to moving forward with a transaction as it gives both parties a level of comfort that they have actually reached a meeting of the minds as to the most important deal points. A LOI can also serve as a psychological deterrent to a party (or that party's counsel) attempting to reopen and renegotiate issues that have already been agreed upon and documented in the LOI. A LOI can also include provisions which compel a party to take the property off the market for a specified period of time, or negotiate exclusively and/or in good faith with the other party for a specified period of time, or prohibit a party from disclosing any confidential or proprietary information discovered in the course of negotiations and due diligence.

If a LOI is not carefully drafted it may contain ambiguities or internal inconsistencies which create an unreasonable risk of misinterpretation that could lead to costly litigation. However, even a properly drafted "nonbinding" LOI may, despite disclaimers to the contrary, be construed to create a binding contract. Thus it is imperative that clients be advised of the importance of ensuring that their actions are consistent with the intent expressed in the LOI.

3. Nonbinding Letters of Intent.

Most parties using letters of intent do not intend them to function as their binding contract. A LOI that is intended to be completely nonbinding should be as brief as possible and should be drafted to avoid the implication that it contains all of the elements of a binding contract.

To avoid having a LOI construed to be a binding contract, it is prudent to include a disclaimer expressing the parties' intent that the LOI not be construed as a binding contract. A comprehensive disclaimer may include statements such as: (a) the LOI is intended merely as an outline to assist the negotiating parties in attempting to reach a mutually acceptable agreement; (b) no promises have been made or relied upon; (c) neither party has the right to infer an agreement to negotiate the remainder of the terms of the contract in good faith or exclusively with each other; or (d) the parties do not intend to be contractually bound until their respective attorneys and/or boards of directors approve the form and content of the contract and the contract is fully executed by both parties. Bear in mind that if a LOI says that the contract is subject to the approval of the party's attorney and/or board of directors, then the covenant of good faith and fair dealing which is implied into all agreements will require that the party must actually submit the proposed contract to its attorney and/or board for approval. If a party does not want to execute contract, it should be relatively simple to get its attorney or board of directors to certify to the other party that the contract has been reviewed and is not approved.

Of course, despite disclaimers to the contrary, a LOI may be treated as a binding contract, depending on a court's determination of what the parties intended. Courts infer intent from the following:

- conduct of parties;
- the LOI language;
- context of negotiations (parol evidence may be introduced that oral promises were made and relied upon); and
- custom.

Obviously, the more carefully worded the disclaimer, the better the argument that the parties' intent not to be contractually bound is actually reflected in the terms of the LOI; however, as noted above, if the parties' conduct is inconsistent with the express terms of the LOI, there is no disclaimer strong enough to convince a court to exclude the parol evidence of the contrary intentions of the parties. For this reason it is important to counsel clients to be sure to act in a manner which is consistent with their objectives and intentions. A seller that delivers possession of the property to the buyer and makes no objection to the buyer spending a substantial sum of money on making improvements to the property prior to the closing will probably have a difficult time convincing a judge that the parties did not intend to be contractually bound merely because they never actually signed a purchase/sale agreement.

4. Partially Binding Letters of Intent.

Even when a court is willing to acknowledge that a LOI was not intended by the parties to function as a binding contract, the court may infer from parol evidence of the parties' conduct or oral promises that the parties had agreed to negotiate with each other in good faith and thus would be prohibited from abandoning contract negotiations by insisting on any terms that are inconsistent with the terms set forth in the LOI.

A LOI may also bind parties to issues that remain pertinent even if a purchase/sale agreement is not signed. If it is intended that a LOI be partially binding on the parties as to one or more specific obligations (e.g., binding as to the obligation to (a) negotiate in good faith, (b) negotiate with the other party exclusively for a specified period of time, (c) keep the terms of the deal being negotiated confidential, or (d) require one party to pay for legal fees, broker's commission and/or the preparation of a space plan, even if a contract is not agreed to) then it is important that such provision be inserted into the LOI *after* any disclaimer provision so that it is clear that only the expressly described provisions inserted after the disclaimer are intended to be binding and none of the other provisions of the LOI are intended to be binding on the parties.

5. Binding Letters of Intent.

The party with the most leverage at the LOI stage of negotiations may actually want the LOI to be binding on the other party, or at least function to deter the other party from attempting to improve its deal over the period of time it takes to finalize a contract. Most brokers and attorneys feel that it is not honorable to ask for a concession that their client already conceded in the LOI (and even if they do ask, they are generally prepared to accept defeat).

Pursuant to California Civil Code Section 1550, the four essential elements of an enforceable contract are:

- the parties are legally capable of entering into a contract;
- the parties have reached a mutual agreement;
- the subject of their agreement is not illegal; and
- each party receives consideration.

A contract that contains all these elements may create a binding obligation upon a party to do -- or not to do -- a certain thing. An enforceable contract to buy or sell real property should identify all the necessary parties (at a minimum, the buyer and the seller). The seller should be the actual owner of the property. Both the seller and the buyer will want to determine that the person signing the contract has the authority to bind the entity the person is signing on behalf of. An enforceable contract should also clearly describe the subject property, the consideration to be paid for the sale of that property and the date by which the closing must take place.

Ordinarily, a mere promise to buy or sell property would not create a legal duty on the part of the person making a promise (promisor) due to the absence of consideration (what was bargained for). Because consideration is not given until the deal closes, a promise to buy or sell property by itself is generally not enforceable. However, a promise is a binding obligation even without payment of consideration if three factors are satisfied:

- the promise is one that the promisor reasonably should have expected would cause the party to whom the promise was made (promisee) to take action or refrain from taking some action of a definite and substantial nature;
- the promise does not in fact induce the promisee into taking or refraining from taking such action; and
- injustice can be avoided only by enforcement of the promise.

Thus, a promisor may be liable for damages under the equitable doctrine of promissory estoppel if the promisee can prove that:

- the promisor made a clear, unambiguous oral promise during negotiations;
- the promisee relied upon the promise;
- the promisee's reliance was both reasonable and foreseeable; and
- the promisee actually was injured as a result of relying on the promise.

A party desiring a binding LOI will want the LOI to include a recitation of all of the promises made to such party by the other, the consideration given for those promises and a statement that the party has relied upon those promises to such party's detriment. Additionally, a LOI that is intended to be binding should be as detailed as possible and address all potentially controversial issues in sufficient detail to preclude any further negotiation on such issues when the first draft of the contract is circulated for review.

Conversely, the party with the least leverage probably wants a LOI that is very brief, covering only the most basic deal points and leaving as much open for negotiation later as possible. Leverage is something that can change with time, so it is almost always advantageous to the party with the least leverage to leave the door open to a possible

improvement in its leverage by agreeing to as few deal points up-front as possible. The downside of this strategy is that some points are generally deemed to have been conceded if they are not addressed in the LOI.

6. Drafting Tips.

Even the briefest LOI should be reviewed carefully to ensure it is consistent with the client's objectives, contains no internal inconsistencies or ambiguities, and no critical information is missing.

If a LOI is intended to be binding, or partially binding, it should address what remedies will be available to the non-defaulting party in the event of a breach of the LOI. Examples of remedies to consider include liquidated damages, recovery of actual out-of-pocket costs, recovery of lost profits (if the property is taken off the market for a period of time while the parties were obligated to negotiate with each other exclusively), specific performance or other injunctive relief.

If a LOI is intended to be binding, be sure to include provisions addressing the following issues:

- All parties, including lenders if construction financing is an issue, should be identified clearly.
- The property that is the subject of the LOI should be identified in as much detail as possible.
- The closing date should be included and the parties should determine what will happen if the closing does not occur by that date.
- If an LOI is intended to be binding or partially binding, the LOI should address available remedies in the event of a breach of the LOI. For example, the LOI may specifically provide for liquidated damages, recovery of out-of-pocket costs, recovery of lost profits, or injunctive relief.
- If some provisions of the LOI are binding, state whether they will continue indefinitely or expire if a contract is not signed by a specified date.

7. Sample Disclaimers.

The more carefully worded the disclaimer, the stronger the argument that the parties' intent is reflected in the LOI. No disclaimer can by itself completely protect your client; however, the following sample disclaimers illustrate some of the common disclaimers found in the various types of LOIs.

(a) **Nonbinding LOI.** This LOI reflects our understanding, at the present time, of certain preliminary discussions we have had concerning the purchase/sale of the property and is intended to be an outline to assist us in preparing a definitive purchase/sale agreement. This LOI does not obligate us to negotiate with each other (in good faith or otherwise) and/or to proceed to completion of a signed purchase/sale agreement. This LOI is not intended to contractually bind either of us in any way, nor shall we be legally bound until an agreement, in form and content satisfactory to each of us and our respective counsel and our respective boards of directors (in their sole discretion) is fully executed by us. Neither party shall be entitled to rely upon this LOI nor any promises (whether oral or written) which may have been made or which may be made in the future, in connection with the negotiations pertaining to the purchase/sale of

the property, except as may be contained in a fully executed purchase/sale agreement. Seller shall be entitled to negotiate with other prospective buyers and buyer shall be entitled to negotiate with other prospective sellers pending the full execution of a purchase/sale agreement.

(b) **Binding LOI.** Within ___ days after the execution of this LOI, the parties shall execute a purchase/sale agreement in the form of the agreement attached hereto as Exhibit "A". [Exhibit "A" should be a form of agreement with the blanks filled in.]

(c) **An Agreement To Negotiate In Good Faith.** Please confirm that you are willing to proceed in good faith to negotiate a mutually acceptable purchase/sale agreement by executing a copy of this LOI where indicated below and returning it to the undersigned. Execution of this LOI shall not obligate either party to accept any particular terms, but will preclude both parties from insisting on any terms which are inconsistent with those terms described in this LOI. It is expressly agreed that the form and content of the purchase/sale agreement must be mutually acceptable to both parties and their respective counsel and that if a mutually acceptable purchase/sale agreement is not agreed to and executed by both parties on or before _____, neither party shall have any further obligation to continue negotiating with the other.

(d) **Optional Provisions.** To induce buyer to proceed to negotiate with seller to purchase the property, seller agrees to withdraw the property from the market and seller will not entertain offers to purchase the property nor negotiate with any other party to sell the property [(during the pendency of this negotiation) or (until [insert date])].

If either party hereto fails and/or refuses to negotiate in good faith, the other party may terminate this LOI and recover from the other party [(liquidated damages in the sum of \$_____) or (its out-of-pocket costs incurred in the course of negotiation including, without limitation, attorneys' fees, consultants' fees, architectural and engineering fees, and all related costs)]. If any legal action is brought to recover such [(liquidated damages) or (out-of-pocket costs)], the prevailing party in such action shall be entitled to recover its reasonable attorneys' and expert witnesses' fees and costs.

[Note that if you include a liquidated damages provision, the text should be bold, in all capital letters, in at least 10 point type and the provision must be signed separately or initialed by both parties to the contract (Civil Code Section 1677). You may prefer to consider providing for other types of remedies, including injunctive relief (such as to prevent the seller from negotiating with and selling to a third party), or special damages (such as lost profits or loss of bargain)].

B. OPTIONS TO PURCHASE.

An option to purchase real property is a contract whereby the property owner/seller ("**Optionor**") in consideration of receipt of an option fee, agrees to sell the identified property to the holder of the option ("**Optionee**") at either an agreed upon price or for a price to be determined pursuant to an agreed upon pricing formula, if the Optionee elects to exercise the option to purchase within a specified period of time. In exchange for the payment of the option fee paid by the Optionee, the Optionor agrees to keep the property off the market and provide the Optionee with the exclusive right, during the specified period of time, to purchase the property, pursuant to agreed upon terms and conditions. An option to purchase functions in much the same manner as an agreement to purchase with a liquidated damages provision for failure to close within a specified period of time. The Optionee has no obligation to purchase the property until the option is exercised.

An option without payment of any consideration by the Optionee is revocable at any time. An option for which consideration is paid by the Optionee is irrevocable.

1. Compare to Rights of First Offer and Rights of First Refusal.

Two other forms of agreements that are similar to an option to purchase are the "right of first refusal" and the "right of first offer." The primary distinguishing factor between these rights, and the option to purchase, is that the owner of the property controls the timing of the sale of the property in the right of first offer and right of first refusal, whereas the buyer controls the timing of the sale by exercising an option to purchase.

(a) **Right of First Refusal.** A right of first refusal give the prospective buyer the right to match any offer to purchase the subject property received from a third party which the owner is willing to accept. Once the owner receives an acceptable offer from a third party, the owner is obligated to notify the holder of the right of first refusal of the essential terms of the offer and such holder then has a specified period of time to exercise his or her right to match the proposed terms of that offer. The right of first refusal agreement (or provision) usually allows the owner to sell the property to any third party on terms which are not materially different than those described in the notice given to the holder of the right of first refusal if the holder of the right of first refusal fails to timely exercise the right of first refusal. Usually a right of first refusal provides that if the terms of the offer are materially altered after the holder declines to exercise the right of first refusal, the owner must submit the revised offer to the holder of the right of first refusal before the owner can sell the property to a third party.

(b) **Right of First Offer.** Most owners dislike giving a right of first refusal as it requires the owner to incur the cost of marketing the property and depresses the enthusiasm of prospective buyers who know that the holder of the right of first refusal can match their offer and purchase the property out from under them. Consequently, most owners prefer to give a right of first offer which merely requires the owner to give the holder of the right of first offer notice of when the owner is ready to sell the property and the terms and conditions upon which owner is prepared to sell the property. If the holder of the right of first offer does not timely exercise his/her right of first offer, the owner may sell the subject property on terms equal to or better (for the seller) than those offered. As with the right of first refusal, most right of first offer provisions provide that if the terms of the offer are materially altered (to be more favorable to the buyer) after the holder declines to exercise the right of first offer, the owner must submit the revised offer to the holder before selling the property to a third party.

2. Timeliness.

An option to purchase generally must be exercised within a fixed period of time or it automatically terminates by its own terms. If there is no agreed upon fixed period within which the option must be exercised, the option must be exercised within a reasonable time. See *Bergin v. VanDersteen* (1951) 107 CA2d 8, 13-14, 236 P2d 613, 617. A belated effort to exercise an option to purchase will not be effective to create a binding bilateral purchase and sale agreement. See *Wightman v. Hall* (1923) 62 CA 632, 217 P580, 580-581. Be aware however, that there are cases in which judges have excused "minor delays" in the exercise of an option provided the Optionor will not suffer undue hardship and is adequately compensated by the Optionee for the delay (See *Holiday Inns of America, Inc. v. Knight* 1969) 70 C2d 327, 331, 74 CR 722, 725 and Civil Code Section 3275).

Upon the timely and proper exercise of the option to purchase, a binding bilateral contract is created (i.e., the Optionor is obligated to sell the property, and the Optionee is obligated to purchase it).

3. Requirements for Option to Purchase.

(a) **Statute of Frauds.** An option to purchase is a contract to purchase an interest in property; therefore, it is subject to the requirements of the Statute of Frauds (Civil Code Section 1624(c)). Consequently, an option to purchase must be in writing and signed by the "party to be charged" (Civil Code Section 1624(c)). In order to satisfy the Statute of Frauds, the option agreement must (i) identify the parties, (ii) state the duration of the option term, (iii) describe the property sufficiently so that it can be identified, (iv) state the purchase price, and (v) describe the material terms and conditions of the proposed purchase and sale.

The terms must be identified with enough certainty that the option is capable of being enforced by an action for specific performance. (See Civil Code Section 3390(5)). It is not necessary that the terms be spelled out specifically as long as a formula or other clear standard for determining the terms is provided. For example, identifying the purchase price as the "fair market value" is sufficient for satisfying the purchase price requirement (See *Good West Rubber Corp. v. Munoz* (1985) 170 Cal. App. 3d. 919, 216 Cal. Reporter 604). Note, however, that it would be advisable to clearly spell out a definition of "fair market value" and describe how "fair market value" is to be determined in order to avoid the potential for costly litigation. An option to purchase that merely states that any one or more material terms shall be mutually agreed upon at sometime in the future is not enforceable

(b) **Sufficient Consideration.** An option to purchase must be supported by sufficient consideration (Civil Code Section 1550(4)). The consideration does not have to be substantial, but it does need to be "valuable" (See *Kowal v. Day* (1971) 20 Cal. App. 3d. 720, 98 Cal. Reporter 118). This requirement has been interpreted broadly to include cash payments of as little as \$0.25 (See *Marsh v. Lott*, 8CA 384, 389-390 (1908)), as well as giving up of a benefit, or the incurring of a detriment (See Civil Code Section 1605). Although it is common practice to recite that the option is given "for good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged", the mere recital of consideration is not conclusive. A written instrument is presumptive evidence of consideration (See Civil Code Section 1614). The burden of rebutting that presumption and showing the lack of sufficient consideration lies with the party seeking to avoid the option contract (See Civil Code Section 1615). Without sufficient consideration, an option to purchase is rendered nothing more than an offer to sell which the owner may revoke at any time before the offer is accepted (i.e., the option is exercised). (See *Kelly v. Rouse*, 188 CA2d 92, 96, 10 CR235, 238 (1961).)

4. Benefits and Detriments of Options to Purchase.

(a) **Optionee's Perspective.** From the Optionee's perspective, there are many advantages to obtaining an option to purchase. These advantages include:

(i) **No Obligation.** The Optionee's only legal obligation in connection with the option is to tender consideration for the option (the "**option fee**") to the Optionor. If the Optionee elects to purchase the property, the option fee is usually applied toward the purchase price.

(ii) **Time to Complete Due Diligence.** The option period usually is long enough to allow the Optionee to perform extensive due diligence concerning the property

at a more leisurely pace than might otherwise be allowed in a purchase/sale agreement. The extended due diligence period can be essential to a buyer who is considering developing the property or using the property in a different manner, which necessitates obtaining entitlements or other governmental approvals or permits or when the buyer is attempting to assemble several adjacent parcels and needs to tie them all up before committing to purchase any single one.

(iii) **Fix the Purchase Price.** The option agreement usually provides for a fixed purchase price or a specific mechanism for determining the purchase price. It is clearly to the Optionee's advantage if the purchase price can be fixed in an appreciating market. In a decreasing market, the Optionee can decline to exercise the option and simply negotiate with the seller from scratch.

(b) **Optionor's Perspective.** Because an option to purchase is essentially a unilateral contract favoring the Optionee, options to purchase are not as desirable from an Optionor's perspective:

(i) **Enhances Optionee's Interest in Purchasing Property.** If the Optionor does not have a ready, willing and able buyer for the subject property, and would prefer not to invest much time or money in marketing the property, the granting of an option to purchase may be a palatable alternative for the owner of the property to consider granting. This is especially true if the option period coincides with the period during which the Optionor prefers to retain title to the property. By granting the option to purchase, the Optionor hopes to whet the appetite of the Optionee, who will presumably perform due diligence during the option period and become emotionally (if not financially) invested in moving forward with the purchase of the property.

(ii) **Accelerated Closing.** Generally, once an option is exercised, there are very few, if any, contingencies to the closing. Because the Optionee has had sufficient time to do his or her due diligence, the period between the exercise of the option and the actual closing of a transaction is typically very short.

(iii) **Restricts Marketability of Property.** A significant deterrent to the granting of an option to purchase is the fact that it makes the property virtually unmarketable to third parties until the option period expires.

(iv) **Market Value Fluctuations.** An option to purchase frequently locks the Optionor into a fixed selling price. Thus, unless the option agreement reserves the right to adjust the purchase price based upon its increased market value, in an appreciating real estate market, the Optionor runs the risk of being obligated to sell the property at an amount that is below the property's fair market value. Consequently, the Optionor risks losing any appreciation that accrues during the option period. If the property value decreases during the option period, the Optionee is not going to be motivated to exercise the option, so the Optionor will have lost the sale to the Optionee and may have lost a potential sale to a third party that would have purchased the property during an earlier part of the option period, when the market was stronger, but for the option encumbering the Optionor's ability to transfer the property.

(c) **Tips for Drafting Options to Purchase.** When drafting an option agreement, it is important to recognize that the granting of the option is only part of the transaction. The terms of the purchase and sale agreement should be documented as extensively as possible. The option to purchase should contain sufficient specificity that it is effectively self executing upon the exercise of the option. Ideally, a fully negotiated purchase/sale agreement should be attached to, or incorporated into the option agreement. The option agreement should include all relevant terms of the transaction,

including (i) the purchase price and the manner of payment, (ii) the terms of the escrow, (iii) the allocation of costs, (iv) the proration of utilities and taxes, (v) the condition of title and the type of title report, (vi) the manner in which possession will be delivered, (vii) the impact of any damage, destruction or condemnation during the period after the option is exercised and prior to the closing, (viii) the right to conduct due diligence or enter upon the premises during the option period, and (ix) broker compensation.

5. Record Option Rights.

The Optionee should take the necessary steps to preserve his or her position vis a vis any bonafide third party purchasers. This is typically done by either recording the option agreement itself, or recording a memorandum of the option agreement sufficient to put a third party on notice of the existence of the option agreement. The recordation of the option agreement or a memorandum of option creates a cloud on the Optionor's title. Thus, the Optionor should insist that the Optionee deliver to Optionor, concurrent with the exercise of the option agreement, a quitclaim deed or other recordable written release of its option which Optionor is authorized to record if and when the option period expires without the option being exercised.

6. Title Insurance.

Options to purchase and rights of first offer and first refusal create an insurable interest in real property. The optionee should consider obtaining title insurance to ensure the priority of the Optionee's interest. By obtaining title insurance the Optionee will receive assurance as to the priority of the option *vis a vis* other existing liens or rights with respect to the subject property.

C. EARNEST MONEY.

To demonstrate that the buyer is serious, upon the execution of either (i) an offer, (ii) a LOI or (iii) a purchase/sale agreement, most buyers make an up-front cash deposit, to be applied towards the purchase price, which is usually held in escrow until the closing (or the buyer's timely notification to the escrow holder that any one or more of the contingencies has not been satisfied). Such a deposit is frequently referred to as either "earnest money" or a "good faith deposit." The earnest money usually remains refundable until the buyer completes his/her due diligence and all of the buyer's contingencies have been waived. In consideration of the delivery of the earnest money, the seller is usually required to keep the property off the market and to negotiate exclusively with the buyer. Note that a "down payment" is not the same as a good faith deposit. A down payment refers to that portion of the purchase price which is not funded by the buyer's lender, and is paid directly by the buyer. The down payment usually is paid a few days prior to the closing, whereas a good faith deposit is usually delivered to the escrow holder when the purchase/sale agreement is executed and escrow is opened.

1. Size of Good Faith Deposit.

A buyer will usually attempt to deliver the smallest good faith deposit that will motivate the seller to take the buyer's offer seriously in order to minimize the buyer's loss if he/she decides not to consummate the transaction after the good faith deposit has gone "hard." Sometimes although the initial deposit is relatively small, the buyer sweetens the deal by offering to deliver a larger deposit when all the contingencies have been waived. A seller usually attempts to obtain the largest deposit possible from a prospective buyer in order to (a) discourage the buyer from walking away from the transaction, and (b) obtain enough money to compensate the seller for taking the property off of the market. In residential transactions, the good faith deposit usually does not exceed three percent

(3%), because Civil Code Section 1675 limits the amount of liquidated damages a seller in a residential transaction may receive to a reasonable amount, which is generally presumed not to exceed three percent (3%) of the purchase price.

2. Interest Bearing Account.

Because the earnest money deposit usually remains refundable until the buyer has completed the buyer's due diligence and waived all contingencies, the deposit may be held in escrow for an extended period of time. Buyer should request that the earnest money be deposited in a state or federally chartered bank in an interest bearing account whose term is appropriate and consistent with the timing requirements of the transaction. The interest should accrue for the benefit of buyer. Note that most escrow holders will access a fee for setting up an interest-bearing account; however, if the deposit is significantly large and/or the period of time it is held is lengthy, the amount of interest earned during the period the money is held in escrow is usually far in excess of the set-up fee.

3. Liquidated Damages.

The amount of earnest money is frequently tied to a liquidated damages provision.

(a) Liquidated Damages – Seller's Point of View.

(i) Liquidated damages provisions can be helpful to a seller because the seller can recover a specified amount of money in the event of a buyer default without having to prove the seller's actual damages. Without a liquidated damages provision, if the buyer defaults a seller may recover the amount by which the purchase price exceeds the fair market value of the property on the scheduled closing date, plus consequential damages and interest (Civil Code Section 3307). The seller has the burden of proof as to the amount of seller's actual and consequential damages. If the purchase/sale agreement includes a liquidated damages provision, the seller still must prove the buyer breached the contract, but will not be obligated to prove up the seller's damages.

(ii) On the downside, in a declining market liquidated damages may prove to be insufficient to compensate the seller for his/her actual damages if the buyer defaults, and so the decision to incorporate a liquidated damages provision into a contract should be considered on a case by case basis, rather than adopted merely because it is part of the boilerplate. As discussed above, in residential transactions liquidated damages generally cannot exceed three percent (3%) of the purchase price, but there is no limit on the maximum amount of actual and consequential damages a seller may recover if the seller is successful in proving such damages.

(b) Liquidated Damages – Buyer's Point of View.

(i) Liquidated damages serve to cap the buyer's exposure and essentially function like an option fee paid to the seller to tie up the property for a certain period of time.

(ii) Liquidated damages are far easier for a seller to recover since the seller is not required to prove his/her damages, or even that the seller was damaged at all. In a rising market the seller may actually recover liquidated damages even if the seller is able to sell the property for more than the contract price.

(c) **Uses; Requirements.** Although liquidated damages provisions can be included to address a breach by either party, they are typically used to address the

seller's remedy in the event of a breach by buyer. Liquidated damages provisions can be used in the LOI to cover the seller's loss if, for example, the LOI requires the seller to cease marketing the property for an extended period of time, and the parties thereafter fail to come to an agreement. The requirements for liquidated damage provisions are set forth in Civil Code Sections 1671 and 1677; which provide:

Civil Code Section 1671

Validity of Liquidated Damages Provision (Nonresidential Property)

(a) This section does not apply in any case where another statute expressly applicable to the contract prescribes the rules or standard for determining the validity of a provision in the contract liquidating the damages for the breach of the contract.

(b) Except as provided in subdivision (c), a provision in a contract liquidating the damages for the breach of the contract is valid unless the party seeking to invalidate the provision establishes that the provision was unreasonable under the circumstances existing at the time the contract was made.

(c) The validity of a liquidated damages provision shall be determined under subdivision (d) and not under subdivision (b) where the liquidated damages are sought to be recovered from either:

(1) A party to a contract for the retail purchase, or rental, by such party of personal property or services, primarily for the party's personal, family, or household purposes; or

(2) A party to a lease of real property for use as a dwelling by the party or those dependent upon the party for support.

(d) In the cases described in subdivision (c), a provision in a contract liquidating damages for the breach of the contract is void except that the parties to such a contract may agree therein upon an amount which shall be presumed to be the amount of damage sustained by a breach thereof, when, from the nature of the case, it would be impracticable or extremely difficult to fix the actual damage.

Civil Code Section 1677

Contract Provisions Required

A provision in a contract to purchase and sell real property liquidating the damages to the seller if the buyer fails to complete the purchase of the property is invalid unless:

(a) The provision is separately signed or initialed by each party to the contract; and

(b) If the provision is included in a printed contract, it is set out either in at least 10-point bold type or in contrasting red print in at least eight-point bold type.

D. STATUTE OF FRAUDS.

The statute of frauds (all states have adopted some form of a statute of frauds) requires that certain types of contracts must be in writing to be enforceable. In California, the Statute of Frauds is set forth in Civil Code Section 1624. Civil Code Section 1624 provides, in pertinent part, as follows:

(a) The following contracts are invalid, unless they, or some note or memorandum thereof, are *in writing* and subscribed by the party to be charged or by the party's agent:...

(3) An agreement for the leasing for a longer period than one year, or for the *sale of real property*, or of an interest therein; such an agreement, if made by an agent of the party sought to be charged, is invalid, unless the authority of the agent is *in writing*, subscribed by the party sought to be charged. (emphasis added)

The requirement that a contract transferring an estate in real property with a term of more than one year be set forth in writing is also found in Civil Code Section 1091, which reads as follows:

An estate in real property, other than an estate at will or for a term not exceeding one year, can be transferred only by operation of law, or by an instrument in writing, subscribed by the party disposing of the same, or by his agent thereunto authorizing by writing.

(See also Code of Civil Procedure Section 1971.)

The Statute of Frauds also requires the following real estate related contracts to be in writing: (i) promises to answer for the debt of another, (ii) agreements authorizing or employing an agent, broker or other party to purchase or sell real estate, and (iii) agreements to satisfy indebtedness secured by a deed of trust on the property purchased (Civil Code Section 1624(a)(2), (4) and (6)). The purpose of the Statute of Frauds is to prevent fraud. The Statute of Frauds may be used as a defense against enforcement if either party to the contract has not properly executed the requisite written agreement but cannot be used as a "sword."

1. Contract Must be In Writing.

The Statute of Frauds only requires that evidence of the applicable contract be in writing. The writing can take any form and it may be comprised of pieces of several documents (i.e., the writing need not be a single document). When the "writing" is comprised of pieces of several documents, the Statute of Frauds is complied with if any one of such documents is signed by "the party to be charged" as long as the various pieces indicate that they relate to the same transaction. (See Restatement 2nd Contracts Section 132).

2. Signed by the Party to Be Charged.

The writing must be signed by the party against whom enforcement of the contract is sought or by his/her authorized agent. No special manner of execution is required by the Statute of Frauds. The signature does not need to be handwritten; it may be typed, printed rubber stamped or even in electronic form. Because the signature merely needs to be a symbol made or adopted with an intention, actual or apparent, to authenticate the writing as that of the signer (see, Restatement 2d, Contracts Section 134; UCC 1201 (39), 2201 (1)), even nicknames and initials are sufficient, so long as they were intended as the equivalent of legal signatures (See, e.g., *Wiener v. Mullaney*, (1943) 59 Cal. App. 2d. 620).

3. Execution by Agent.

The authorized agent of the party to be charged may provide the requisite signature in accordance with the Statute of Frauds provided that the agent's authority is evidenced by a writing signed by the principal to be charged. This is known as the "equal dignities" rule (Civil Code Section 1624(a)(3)).

4. Requirement of Essential Terms.

Although not found in the Statute of Frauds, there is an ancillary requirement that the writing contain all of the necessary and material terms of the parties' agreement. (See *Marriage of Shaban* (2001) 88 CA4 th 398, 405-406.) Under Civil Code Section 3390(5) a party may not seek specific performance unless the terms of the agreement are "sufficiently certain to make the precise act which is to be done clearly ascertainable". An enforceable contract must identify the subject matter of the contract (Restatement 2 nd Contracts Section 131) indicate that the parties intended to be contractually bound (Restatement 2 nd Contracts Section 131(b)), and state "with reasonable certainty the essential terms of the unperformed promises in the contract" (Restatement 2 nd Contracts § 131(c)). The essential terms of any contract will vary from transaction to transaction, but a real property purchase/sale agreement will, at a minimum, include the identity of the buyer and seller, a satisfactory description of the property, the purchase price, and the terms and manner of payment. Although parol evidence may not be used to supply any missing essential term, it may be used to clarify an ambiguous material term.

As noted above, parol evidence may not be introduced if it is inconsistent with the written document; however an exception to the Statute of Frauds exists when one party partially (or fully) performs, resulting in a detrimental change of position in reliance on a real property sale contract that otherwise does not satisfy the Statute of Frauds. The rationale for this exception is that the party would not, in good faith, have undertaken such performance absent a binding contract and that performance itself becomes sufficient evidence of the contract. The "partial performance" needed to circumvent the Statute of Frauds must consist of acts which would not have been performed but for the contract and such acts must clearly be related to and in furtherance of the agreement that is sought to be enforced (e.g., buyer taking possession of the property and/or making improvements to the property). The mere payment of the purchase price will not be sufficient to satisfy the "partial performance" requirement.

5. Effect of Non-Compliance With the Statute of Frauds.

Noncompliance with the Statute of Frauds does not render a contract automatically void, but it is voidable at the election of the party that does not wish to be bound by such contract. The defense of noncompliance with the Statute of Frauds should be raised as soon as possible as it is deemed waived if not timely raised, usually either by affirmative defense, demurrer or objection to or motion to strike parol evidence of contract in violation of the Statute of Frauds at trial.

Even if the defense is timely raised, a party may be estopped to assert the Statute of Frauds as a defense where one party has been induced to change his/her position to his/her detriment based upon reliance on promises made if such party was injured as a result of such reliance.