

**Buyers and Sellers: Dealing with the Liquidated Damages and
Arbitration Clauses in the Residential Purchase Agreement**

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The purchase agreement used in the vast majority of residential home sales in California is the Residential Purchase Agreement (designated form RPA-CA at the bottom of the form), published by the California Association of Realtors. Two of its provisions, dealing with liquidated damages (Paragraph 16) and mandatory arbitration (Paragraph 17.B), must be individually accepted or rejected by buyers and sellers, who are often confused about both the meaning of the provisions and whether to include them in the contract.

Since these are legal issues, buyers and sellers cannot expect their real estate agents to make the decision for them about whether to accept or reject these provisions, or even to suggest how their client should respond. The only written information on these provisions that most buyers and sellers will see, other than the language of the provisions themselves, is found in a separate 10-page California Association of Realtors form, Form SBSA, the Statewide Buyer and Seller Advisory. Paragraphs 41 and 43 of the current version, respectively, deal with Liquidated Damages and Arbitration. The purpose of this article is to supplement those materials and shed some additional light on those decisions for sellers and buyers.

Liquidated Damages

When the buyer and seller agree, as part of the contract, to a liquidated damages provision, they are agreeing in advance that should the buyer breach the purchase agreement, the seller is entitled to the pre-agreed upon amount of damages. The boilerplate of the RPA-CA sets that damage amount as the amount of the deposit actually paid, which is found on the first page of the contract. The reason for this pre-agreement regarding the amount of damages is because without that agreement, it is extremely difficult to fix actual damages. For example, let us assume that the buyer breaches the day before the close of escrow by canceling the contract – what are the seller’s damages? In a rapidly rising market, the seller may actually be able to make more by selling the property to another buyer, while in a rapidly decreasing market, having the home off the market for a couple of months may mean a large drop in the home’s market value. Not only is the amount of “real” damages difficult to determine, but from a practical standpoint the damages can be determined only after a legal battle that decides both who breached and the amount of actual damages suffered. Executing the liquidated damages provision means that the parties will avoid the time and expense of a more protracted legal battle to determine actual damages, a burden that can be very significant. While the result may not seem fair to one side or the other in a particular set of circumstances, in fact most buyers and sellers do execute the liquidated damage provision of Paragraph 16 of the RPA-CA. Pre-determining the damages means actual damages rarely matches the liquidated damage amount. The parties do, in theory at least, avoid a fight and ensure certainty.

Given that the amount of liquidated damages is tied to the amount of the deposit, the size of the deposit becomes a significant issue when making or receiving an offer. Both buyers and sellers should remember that a buyer who breaches the purchase agreement after signing the liquidated damages provision risks losing the entire amount of the deposit. There is one significant exception to that rule: for residential purchases of one to four units, California law sets the maximum amount of liquidated damages at 3% of the purchase price.

Remember too that the liquidated damages provision determines the amount of damages the seller will receive, but it does not mean that release of the funds will be automatic. The escrow holder is a neutral third party and can only act with the consent of both parties to the escrow. That is why I said above that by signing the liquidated damages clause the parties “in theory” ensure certainty and avoid a fight. A dispute over which party breached the RPA-CA may still result in a legal fight to determine who breached. The liquidated damages provision only determines the amount of the damages. It is the rest of the RPA-CA’s provisions that determine which party is in breach.

Arbitration

Arbitration is an alternative to a court trial. Instead of the plaintiff, buyer or seller, filing a lawsuit against the other party, followed by the discovery process and, perhaps a year or more later, a trial, arbitrations are designed to be faster and, consequently, less expensive. The same rules of evidence generally apply as in a lawsuit (although there tends to be less formality) but the process is faster – usually 3-5 months – and takes place before a single arbitrator. There is no jury. Just as significantly, the current RPA-CA does not permit an appeal from the arbitrator’s decision, other than under very limited circumstances. Thus those who advise against initialing the arbitration clause usually invoke the fear that the arbitration will either “get it wrong” or, conversely, try to “split the baby” between the two sides. The flip side of these arguments is that the parties have some control over selection of the arbitrator and the total cost and length of time necessary to resolve the dispute are typically significantly less than in court. When one considers the potentially extreme costs of litigation and the fact that, due to the attorney fees clause of the RPA-CA, the losing side may end up paying not only their own attorney’s fees and costs but the other side’s as well, factors favoring arbitration usually prevail for most buyers and sellers and they initial the clause.

One final point – the liquidated damages and arbitration provisions **MUST** be initialed by both sides in the RPA-CA to be effective. If you are a buyer who has initialed both provisions, make sure those provisions are not lost in the back-and-forth of counter-offers and that the sellers initial each provision. If you are a seller and the offer does not include them, make sure your agent puts them in a counter-offer.

If you have a more specific question regarding these provisions, we would be happy to assist you.