

Focus

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Parties Must Create Genuine Option Contract to Avoid Damages Limitation

By David M. Grey

The limitation on liquidated damages in the California Association of Realtor's form "Residential Purchase Agreement" (and "Receipt for Deposit") cannot be circumvented by labeling the deposit as "nonrefundable purchase option monies" according to the recent case of *Allen v. Smith*, 94 Cal.App.4th 1270 (2002).

This form contract is used for almost every home sale in California. The contract limits liquidated damages to the buyer's deposit and no more than 3 percent of the purchase price if the buyer defaults and fails to complete the purchase as per the contract.



The liquidated-damages provision in the Residential Purchase Agreement fulfills the requirements of Civil Code Section 1675 governing liquidated damages in the purchase and sale of residential property.

Use of option contracts can avoid the enforcement problems of liquidated-damages provisions. Under *Allen*, however, the parties must enter into a true option contract and not merely label their agreement as an option. The consideration paid for the option is not an unlawful penalty because the obligation to pay does not arise upon breach of the contract. Instead, payment is made for the privilege of having the unilateral choice to buy the property.

Barbara Allen offered to buy Frank Smith's house for \$1.74 million. She communicated the offer to Smith by the form Residential Purchase Agreement. Smith responded with the form "Counter Offer No. 1." On this form was a handwritten note: "Buyer's increased deposit to be \$80,000 — total deposit of \$100,000 to be released to seller as a nonrefundable purchase option monies."

Both Smith and Allen initialed the liquidated-damages clause in the contract, which stated: "If buyer fails to complete this purchase by reason of any default of Buyer, Seller shall retain, as liquidated damages for breach of contract, the deposit actually paid. However, if the Property is a dwelling with no more than four units, one of which Buyer intends to occupy, then the amount retained shall be no more than 3 percent of the pur-

chase price. Any excess shall be returned to Buyer. Buyer and Seller shall also sign a separate liquidated damages provision for any increased deposit."

Allen made the additional deposit of \$80,000, released the deposit to Smith and released all contingencies contained in the contract. Escrow was to close on June 20, 1999. In May, Allen notified Smith that she would not complete the purchase. Allen conceded that Smith could keep the \$20,000 as liquidated damages and demanded return of the \$80,000.

Smith refused, and Allen filed her action for breach of contract, money had and received, conversion, fraud and specific performance. Both Smith and Allen moved for summary judgment. The trial court granted summary judgment against Allen, finding that Smith's handwritten note in Counter Offer No. 1 was effective to create an option contract for \$100,000.

The Court of Appeals reversed and instructed that summary adjudication be granted in favor of Allen on her breach-of-contract claim. The court concluded that Smith's characterization of the deposit as "nonrefundable purchase option monies" did not convert the Residential Purchase Agreement into an option contract.

The court held that it is the nature of the documents and the obligations of the parties, not labels such as "option" or "liquidated damages," that are dispositive in the interpretation of real estate contracts. "The test is whether ... there is a mutuality of obligation. If both parties are obligated to perform it is an agreement for sale; if only one party is obligated to perform, it is merely an option."

As a general rule, courts favor an interpretation that makes the contract bilateral. The *Allen* court noted that "[a] bilateral contract immediately and fully protects both parties by binding each to its terms on its execution."

The court in *Allen* noted that the form Residential Purchase Agreement and Counter Offer "ordinarily constitute a binding and enforceable contract for the purchase and sale of the described property," citing *Meyer v. Benko*, 55 Cal.App.3d 937 (1976); *Mattei v. Hopper*, 51 Cal.2d 199 (1958).

But the California Association of Realtors form used by the parties in *Allen* has no provision that gave the buyer complete discretion of whether or not to

purchase the property. There was mutuality of obligation because "the contract includes inspection contingencies and requested Allen to complete the inspections and remove all contingencies within 21 days of acceptance. The contract provides that on Allen's removal of contingencies she 'shall conclusively be deemed to have ... [e]lected to proceed with the transaction[.]' A chief advantage of a true option is that it allows the optionee to inspect the property without meeting contingency requirements."

Thus, the buyer under an option contract has complete discretion of whether or not to proceed. By contrast, Allen was obligated to complete the purchase once the contingencies were released. Allen had no discretion and, thus, the form could not be an option contract.

In support of its conclusion that the Residential Purchase Agreement had not been converted into an option contract, the court also noted that there was no period specified in the contract by which Allen's option to purchase had to be exercised. Likewise, the contract contained a "time is of the essence" clause, which has nothing to do with an option to buy.

Finally, the court noted that option contracts grant an irrevocable right to buy the property for independent consideration, with the purchase-and-sale contract usually attached to the option contract as an exhibit. By contrast, Smith and Allen had only the purchase-and-sale documents, with no independent option contract.

Thus, the court held that the mere characterization of the deposit as "nonrefundable purchase option monies" did not create a true option contract and was an unlawful penalty in violation of both Civil Code Section 1675 and the contract's own liquidated damages provision.

Allen serves notice that parties must structure a true option contract when using the forms or risk what is labeled as the option payment being deemed an unenforceable penalty. The seller in *Allen* could have avoided litigation by granting the buyer a true option and then reducing the agreed-upon purchase price by the amount paid for the option.

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