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EARNEST MONEY FORFEITURES

Traditionally, earnest money demonstrates the purchaser's good faith in making an offer and serves as security for the purchaser's performance under an earnest money agreement. However, there recently have been significant changes in the law concerning forfeitures of earnest money deposits.

Generally, if a purchaser defaults under an earnest money agreement, the seller may elect to retain the earnest money as liquidated damages (i.e. forfeiture of the earnest money), to seek actual damages, or to enforce the agreement. In order for a liquidated damages clause to be enforceable, (1) the amount fixed must be a reasonable forecast of just compensation for the harm that is caused by the breach, and (2) the harm must be such that it is incapable or very difficult of ascertainment. Historically, the test of reasonableness of a liquidated damages clause looks to the time that the agreement was entered, without regard to subsequent events. However, in *Lind Building Corp. v. Pacific Bellevue Developments,* 55 Wn. App. 70 (1989), the court considered the fact that the seller sold the property to another purchaser at a substantial profit and held that a liquidated damages clause in an earnest money agreement is unenforceable if (1) the amount of liquidated damages does not represent an effort by the parties to make a reasonable forecast of anticipated damages, (2) the amount of liquidated damages is unreasonable in light of the anticipated or actual loss, or (3) the calculation of actual damages is not difficult of ascertainment or proof. The *Lind* decision created terrible uncertainty and resulted in many disputes over earnest money forfeitures.

In 1991, the Legislature enacted the "safe harbor" statute (RCW 64.04.005) in direct response to the *Lind* decision. Under the safe harbor statute, the forfeiture of an earnest money deposit as the seller's sole and exclusive remedy if the purchaser fails, without legal excuse, to complete the purchase, is valid and enforceable, regardless of whether the seller incurs any actual damages, provided that (1) the total earnest money deposit to be forfeited does not exceed five percent (5%) of the purchase price; and (2) the agreement includes an express provision in substantially the following form:

> "In the event the purchaser fails, without legal excuse, to complete the purchase of the property, the earnest money deposit made by the purchaser shall be forfeited to the seller as the sole and exclusive remedy available to the seller for such failure."

If the property is being purchased for the purchaser's personal use, then the above provision must be separately initialed by both parties. The safe harbor statute is not mandatory; it simply does not apply if the agreement does not satisfy the above requirements. Likewise, the statute does not either prohibit or authorize forfeitures of earnest money deposits exceeding the 5% safe harbor.

Less than four years after the *Lind* decision, the same court (but with different judges) expressly declined to follow the *Lind* decision and held that a liquidated damages clause in an earnest money agreement is enforceable if the amount was, *at the time the agreement was entered into,* a reasonable estimate of just compensation for the purchaser's default. *Watson v. Ingram*, 70 Wn. App 45 (1993).

In *Watson*, the purchaser sued to recover a $15,000 earnest money deposit made on the purchase of a $355,000 house. The purchaser's original offer had included a contingency for the sale of the purchaser's condominium, but the seller would not accept a contingent offer. The seller made a counteroffer containing neither a house sale nor financing contingency, which counteroffer was accepted by the purchaser. The earnest money agreement was entered into *before* the safe harbor statute was enacted, and provided that "[i]n the event of default by Buyer, earnest money shall be forfeited to Seller as liquidated damages, unless Seller elects to seek actual damages or specific performance." The agreement also included the representation that "Buyer has sufficient funds available to close this sale in accordance with this agreement, and is not relying on any contingent source of funds unless otherwise set forth in this agreement."

The purchaser was unsuccessful in selling his condominium by the closing date, and tried several financing alternatives. In the meantime, the seller accepted a back-up offer at a price $25,000 higher than the pending sale. The purchaser requested an extension to continue trying to obtain financing, but the seller refused. Unfortunately for the seller, the back-up offer also failed to close, and the seller finally sold the house ten months later for the same price that the first purchaser had agreed to pay. The purchaser sued to recover the earnest money under the *Lind* case, claiming that the seller had suffered no actual damages, such that forfeiture of the earnest money would constitute an unenforceable penalty.

The *Watson* court cited the safe harbor statute as a "legislative determination that 5 percent of the purchase price is a reasonable amount of liquidated damages in a real estate transaction," and expressly declined to follow the *Lind* decision.

> "[I]n the context of real estate agreements, a requirement that damages be difficult to prove at trial would encourage litigation in virtually every case in which the sale did not close, regardless of whether the earnest money deposit was a reasonable estimate of the seller's damages. This result is directly contrary to the policy reasons for favoring liquidated damages provisions in agreements between parties with equal bargaining power: certainty, assurance that the contract will be performed, and avoidance of litigation."

70 Wn. App. at 56-57.

The court went on to hold that the liquidated damages clause was enforceable, and the earnest money deposit of $15,000 was reasonable, "particularly in light of the fact that the deposit was less than 5 percent of the purchase price." In effect, the court has created a "judicial safe harbor" based upon the statutory safe harbor.

The result from a seller's perspective is that the safe harbor statute no longer offers any benefits over the case law, such that the safe harbor clause is no longer in the seller's best interest. However, because the *Watson* court relied heavily upon the safe harbor statute, the 5 percent limitation should still be used as a guideline for the maximum amount of earnest money that can safely be retained by a seller without proving actual damages.

From the purchaser's perspective, the safe harbor statute still protects the purchaser from personal liability for actual damages and limits the seller's recourse to retaining the earnest money. However, the same benefit can be obtained more easily (without the separate initialing requirement) by including a contractual limitation of remedies. In other words, there never has been a legal barrier to limiting the seller's remedy to retaining the earnest money by contract. The safe harbor statute simply is no longer needed.