

# HOUSE BILL REPORT

## SHB 1699

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**As Passed House:**

March 8, 2005

**Title:** An act relating to agreements for the purchase and sale of real estate.

**Brief Description:** Regulating agreements for the purchase and sale of real estate.

**Sponsors:** By House Committee on Judiciary (originally sponsored by Representatives Lantz, Priest and Tom).

**Brief History:**

**Committee Activity:**

Judiciary: 2/16/05, 2/18/05 [DPS].

**Floor Activity:**

Passed House: 3/8/05, 96-0.

**Brief Summary of Substitute Bill**

- Ensures that courts must enforce liquidated damages and earnest money deposit clauses in real estate buy-sell agreements if they comply with common law requirements even if they are technically defective under the guaranteed enforcement statute.
- Liberalizes the requirements for guaranteed enforcement of liquidated damages and earnest money deposit clauses.

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### HOUSE COMMITTEE ON JUDICIARY

**Majority Report:** The substitute bill be substituted therefor and the substitute bill do pass. Signed by 10 members: Representatives Lantz, Chair; Flannigan, Vice Chair; Williams, Vice Chair; Priest, Ranking Minority Member; Rodne, Assistant Ranking Minority Member; Campbell, Kirby, Serben, Springer and Wood.

**Staff:** Christopher Abbott (786-7119).

**Background:**

Liquidated Damages Clauses

When a party breaches a contract with another, the party hurt by the breach has several options. For instance, the injured party may sue for damages, seek restitution or return of property held by the breaching party, or request that the court compel the breaching party to

perform its end of the bargain. The parties may also specify other remedies in the contract itself.

Sales contracts often include a "liquidated damages" clause. These clauses establish a defined amount of money that the parties agree to pay as damages if they breach the agreement. Parties use liquidated damages agreements to reduce litigation over damages and manage risk when the parties have difficulty predicting the actual harm of a contract breach.

#### Common Law Requirements for Liquidated Damages Clauses

Courts will not enforce liquidated damages clauses unless they satisfy several common law requirements. Most importantly, the amount specified in the liquidated damages clause must be a reasonable estimate of the possible harm from a future breach. Traditionally, courts would also only enforce the clause if the parties inserted the clause because of anticipated difficulty in determining actual damages when a breach occurs. More recently, however, the state Supreme Court has treated actual damages more as a factor in evaluating the reasonableness of the liquidated damages clause than as an independent requirement.

Much of the controversy concerning these clauses revolved around whether an injured party must prove actual damages from the breach before claiming the liquidated damages amount. Before 1989, courts never considered actual damages. In *Lind Building Corporation v. Pacific Bellevue Developments*, however, the Washington Court of Appeals departed from the traditional view, holding that a party who does not prove any actual damages could not enforce the liquidated damages clause even if its estimate of future damages was reasonable when first written. Five years later, the Washington Supreme Court overruled *Lind*, holding that lower-than-expected actual damages were, at most, evidence of an unreasonable liquidated damages clause.

#### Earnest Money Deposits

Many real estate transactions use an earnest money deposit provision. One party (typically the purchaser) agrees in the purchase and sale agreement to deposit a sum of money. A party forfeits the deposit by breaching the contract, allowing the other party to keep the money. Courts treat these arrangements as a form of liquidated damages.

In 1991, the Legislature responded to the *Lind* decision by creating a new law governing earnest money deposits. RCW 64.04.005 guarantees enforcement of an identified earnest money clause regardless of actual damages so long as the clause satisfies the law's requirements. This guarantee only applies when the agreement designates payments as an earnest money deposit and provides that forfeiture of the deposit is the seller's exclusive remedy if another party backs out of the deal.

For earnest money provisions to be enforced under RCW 64.04.005, they must meet the following amount, language, and notice requirements:

- *Maximum Amount.* The maximum amount to be forfeited may not exceed 5 percent of the purchase price.

- *Standard Language.* The agreement must include a forfeiture clause using language set out in the statute.
- *Notice.* In residential home sales, the forfeiture clause must be in the same size typeface as the rest of the agreement and must be initialed by all the parties.

### Consequences of Defective Earnest Money Forfeiture Clauses

According to a recent court of appeals decision, RCW 64.04.005 bars enforcement of an earnest money clause when the clause is defective with respect to the amount, language, and notice requirements. In *Chrisp v. Goll*, decided January 3, 2005, the home seller elected forfeiture of an earnest money deposit as the sole remedy, but the parties did not separately initial the clause as required by law. The court refused to enforce the earnest money provision, holding that the statute's plain language required that the parties retain all remedies allowed by law if the earnest money clause violated the amount, language, and notice requirements. Consequently, if the purchaser reneges on a deal with a defective earnest money clause, the seller may pursue remedies in addition to recovery of the earnest money deposit. *Chrisp* is currently being appealed.

The consequences of violating the amount, language, and notice requirements do not apply to liquidated damages clauses that are not earnest money deposits within the scope of the statute. For example, courts have upheld contracts where the total amount forfeited (including an earnest money deposit and other payments) is as much as 17 percent of the purchase price so long as the earnest money portion itself is no greater than 5 percent of the price. Similarly, if forfeiture of the deposit is not the sole and exclusive remedy, the statute does not apply, and the provision need not meet the amount, notice, and language requirements. These liquidated damage clauses must still comply with the common law reasonableness requirement.

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### **Summary of Substitute Bill:**

#### Liquidated Damages

The guaranteed enforcement requirement in RCW 64.04.005 is extended to all forms of liquidated damages clauses in real estate agreements. Courts must enforce the liquidated damages clause regardless of the seller's actual damages if the following conditions exist:

- the agreement expressly identifies the liquidated damages clause as such;
- the seller's sole and exclusive remedy for a party's failure to complete the purchase is recovery of the liquidated damages; and
- the amount of liquidated damages is no greater than 5 percent of the purchase price.

These requirements apply equally to residential and commercial property transactions.

Liquidated damages clauses that do not satisfy the statute's requirements are instead governed by the common law requirements.

#### Earnest Money Deposits

The notice and language requirements are eliminated, making the requirements for guaranteed enforcement of earnest money deposits identical to the requirements for all liquidated damages clauses. Courts must now enforce an earnest money forfeiture clause regardless of the seller's actual damages if the following conditions exist:

- the agreement expressly identifies the amount paid as an earnest money deposit;
- the seller's sole and exclusive remedy for a party's failure to complete the purchase is recovery of the forfeited earnest money deposit; and
- the amount of earnest money to be forfeited is no greater than 5 percent of the purchase price.

These requirements apply equally to residential and commercial property transactions.

#### Consequences of Defective Earnest Money Forfeiture Clauses

Failure to meet the statutory requirements no longer renders the earnest money forfeiture clause totally ineffective. Instead, courts will evaluate a defective earnest money deposit clause under the common law liquidated damages requirements.

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**Appropriation:** None.

**Fiscal Note:** Not requested.

**Effective Date:** The bill contains an emergency clause and takes effect immediately.

**Testimony For:** Real estate agreements are in a limbo because of the recent Appeals Court decision. After the Court of Appeals changed the rules for enforcing earnest money forfeiture clauses, the Legislature enacted a safe harbor statute to provide a means for parties to guarantee that these clauses would be enforced. The requirement that the parties initial the clause was intended to further consumer protection, but it became a problem when parties often forgot to include their initials. After the Washington Supreme Court overruled the earlier Appeals Court decision, all standardized real estate forms eliminated the initialing requirement as unnecessary. In December 2004, the Court of Appeals interpreted the safe harbor statute as the exclusive means of enforcing liquidated damages and the initialing requirement as necessary. Because of that decision, purchase and sale agreements now either lack an enforceable earnest money forfeiture clause or, in the worst case scenario, are not binding agreements at all. This bill would address an emergency and needs an emergency clause.

**Testimony Against:** None.

**Persons Testifying:** Representative Lantz, prime sponsor; and Bob Mitchell and Annie Fitzsimmons, Washington Association of Realtors.

**Persons Signed In To Testify But Not Testifying:** None.