

# Brokerage Reminder: Deposits in escrow – disbursement of funds upon cancellation



## **A demand for funds based on losses**

The sale of a one-to-four unit residential property is controlled to a great extent by legislative schemes. The intent is to limit or enlarge the contract rights of the buyer and seller as public policy in sales. As designed, the uniform procedures of the schemes alleviate unnecessary burdens which occasionally arise in real estate transactions.

One set of rules addresses the troublesome nature of an escrow disbursing funds held for the buyer when a sales transaction fails to close. Mutual instructions from the buyer and seller are needed before an escrow will disburse the buyer's funds.

The scheme also clarifies the right of the buyer and seller to cancel escrow instructions without also canceling the purchase agreement. When the purchase agreement is canceled, the buyer and seller

eliminate their right to pursue claims they may have against one another in the failed transaction.

[See [RPI Form 401-5](#)]

Escrows do sometimes fail to close. Typically, escrow holds the buyer's **good faith deposit** toward the payment of the purchase price of a one-to-four unit residential property. When the time for closing passes due to the nonperformance of either the buyer or the seller — a breach of the purchase agreement — any funds held in escrow are to be disbursed within 30 days after the person entitled to the funds demands them.

Again, escrow may not disburse funds without mutual instructions from the buyer and seller. So when a demand by one participant for receipt of the funds is disputed by the other participant's refusal to consent, the resolution depends on who has the right to receive the funds held by escrow. [Calif. Civil Code §1057.3]

Usually the escrowed funds are the buyer's good faith deposit toward payment of the purchase price. Under the scheme for relieving escrow of the burden for holding funds until the participants or a court resolve who is entitled to the monies, a seller or buyer who unjustifiably refuses to release the buyer's good faith deposit within 30 days of the others demand for the funds is liable for:

- a money penalty of three times the amount wrongfully withheld by a failure to consent, called **treble damages**, an amount to be greater than \$100 but less than \$1,000; plus
- attorney fees (which frequently exceed the amount in dispute).

The seller or buyer is exposed to liability for these amounts when they:

- interfere with the release of escrowed funds; and
- do not have a good faith, reasonable legal basis for making a claim on the funds. [CC §1057.3(b)(2)]

Within a period of 30 days after the first demand received by escrow for the funds, the buyer and seller are individually obligated to:

- determine who is entitled to the funds; and
- hand escrow **cancellation and release of funds** instructions to clear the deposits out of escrow.

For instance, the dispute arises on the seller's claim they are entitled to the deposit under *forfeiture-of-deposit* provisions contained as boilerplate provisions in outdated purchase agreements. Here, and in spite of the agreed-to provision for forfeiture, the seller is not entitled to any of the buyer's funds unless the seller has suffered **out-of-pocket money losses** due to a breach by the buyer. This financial result is much different from the windfall of a forfeiture received by a seller when the seller has incurred no monetary losses.

Thus, the fully performing seller needs to consent to the release of the escrowed deposit to a breaching buyer, less any unrecovered, *out-of-pocket money losses* the seller actually incurred due to the buyer's breach.

When escrow does not receive mutual instructions to disburse funds within 30 days of a unilateral demand for the funds, the escrow company simply deposits the funds with the court, called an **interpleader**. On the deposit with the court, escrow is relieved of any further responsibility to account for the funds. Escrow then closes out its trust account on this sale's escrow. [Calif. Code of Civil Procedure §386; **Security Trust & Savings Bank v. Carlsen** (1928) 205 C 309]

## A good faith dispute over the right to the deposit

Occasionally, when a sales transaction does not close, a legitimate **good faith dispute** exists between the buyer and the seller over entitlement to the buyer's deposit held by escrow. [CC §1057.3(f)(2)]

However, the good faith standard for a person's refusal to release escrowed funds requires the person to hold a *reasonable belief* they have the right to the funds they have demanded or refused to release. However, on resolution of a *good faith dispute*, neither the buyer nor seller is entitled to receive any penalty or statutory attorney fees. [CC §1057.3(c)]

For example, the seller of any type of real estate cannot reasonably believe they are entitled to the buyer's deposit when a mere cursory reading of the liquidated damages forfeiture prevention codes indicates they have no **right to compensation**. The liquidated damages codes apply in spite of forfeiture wording to the contrary in the purchase agreement's provisions.

Only when the seller has **actually sustained** out-of-pocket money losses on transaction-related expenditures, or the property's value has declined below the agreed price by the date of the buyer's breach, may they properly demand money. If the seller has experienced no related money losses, any demand for money is without legal basis. [CC §§1671 et seq.]

A seller needs to understand a breach of the purchase agreement by the buyer does not bar a refund to the buyer of their entire good faith deposit, undiminished, when the seller incurs no money losses due to the breach. Further, the seller who refuses to release the buyer's deposit and cancel escrow instructions based on the sole fact of the buyer's breach has acted in bad faith. To act in good faith, the seller needs to document they have suffered a transaction-related money loss.

Thus, a seller's adverse and hostile reaction, without more, to a buyer's breach by refusing to timely instruct escrow to refund the buyer's deposit subjects the seller to a civil money penalty and attorney fees. Here, the seller has 30 days following the buyer's written demand for the return of the buyer's funds to instruct escrow to release the funds to the buyer.

# The seller's recovery of money

For a seller to receive any part of the buyer's deposit, the seller must **incur money losses** due to the buyer's wrongful failure to acquire the property. Money losses a seller may have incurred on a buyer's breach include:

- lost rent caused by the terms of the sale;
- a decline in the property's value below the price agreed to by the date of the buyer's breach;
- transactional expenses unrecoverable when the property is resold; and
- other expenditures directly related to the transaction which will go uncompensated (on a resale or retention of the property).

For example, on the buyer's breach, the seller hands escrow instructions to release to the seller a specific dollar amount of the buyer's deposit equal to the seller's out-of-pocket money losses on the failed sale. The funds remaining after escrow deducts its cancellation charges are to be returned to the buyer.

Further, the buyer is requested to sign the disbursement instructions which include cancellation of escrow, but not a cancellation of the purchase agreement. [[See RPIForm 401-5](#)]

The seller also promptly provides the breaching buyer with an **itemized accounting** of their money losses incurred on the sale prior to the breach. [[See RPI Form 401-6](#)]

The buyer, on reviewing the seller's itemized unrecoverable expenses, refuses to sign the instructions. The buyer then demands the seller sign conflicting instructions releasing the entire deposit to the buyer and a cancellation of escrow instructions and the purchase agreement.

[[See RPI Form 181](#)]

By this demand, the buyer wrongfully interfered with the release of funds. The buyer does not have a good faith, reasonable legal basis for a claim on all the funds they deposited into escrow.

If the dispute continues for more than 30 days after the seller instructed escrow to disburse the buyer's funds, the seller may file a money action for:

- the release of the portion of the deposit necessary to reimburse the seller for their itemized money losses;
- a civil penalty of up to \$1,000 against the buyer for wrongfully interfering with the release of funds; and
- attorney fees incurred in the action to recover the funds. [CC §1057.3(b)]

A buyer acts in bad faith when a seller provides complete documentation of their losses and seeks the release of *only* the amount of their losses. The buyer's belief after documentation of losses that they

are entitled to a full refund of their deposit is without legal foundation. Thus, the buyer's demand for a full refund when the seller incurs money losses due to the buyer's breach is **unreasonable**.

However, the seller needs to **document the money losses** they have demanded from the buyer's deposit. A buyer properly challenges, as a forfeiture of their funds, a demand from the seller that does not provide documentation of their actual money losses.

Before the buyer can be reasonably expected to agree to release compensating funds to the seller, they need justification for the amount demanded. If the seller does not provide documentation, the buyer will escape penalties and attorney fees by showing they acted in good faith when they disputed the release of the funds demanded by the seller.

## **Cancel escrow and enforce the purchase agreement**

The primary purpose of the release-of-funds statute is to distance escrow from buyer-seller disputes over funds held in escrow.

Another objective clarifies that the cancellation of escrow on the release of funds **does not cancel the underlying purchase agreement**. By canceling escrow but not the purchase agreement, the rights of either party to litigate any past or future performance of the purchase agreement remain intact. The purchase agreement is not automatically the subject of the cancellation instructions prepared by escrow when funds are released. [CC §1057.3(e)]

For example, a buyer's cancellation of only the escrow instructions due to the seller's nonperformance does not affect the buyer's right to pursue specific performance of the purchase agreement to acquire the property. The purchase agreement remains in effect, unless it too is cancelled as part of the cancellation of the escrow instructions. [[See RPI Form 181](#)]

Further, when the buyer's funds are retained by escrow due to a wrongful claim on them by the seller, or were previously released to the seller under the terms of the sale, a *purchaser's lien* on the property is available to the buyer. The lien may be judicially foreclosed to collect the funds withheld. [CC §§3050; 3375 et seq.]

However, when the seller intends to market the property for sale, the seller and their agent do not want the property tied up by a buyer as part of an on-going attempt to recover funds in a lawsuit.

A seller's agent's best advice to their seller is to consider canceling the underlying purchase agreement at the same time escrow is cancelled — a moment when the buyer is most apt to be willing to cancel the entire transaction in exchange for the release of their funds.

The incentive for the seller and their agent to cancel the purchase agreement is to eliminate any claims the buyer may later make against the seller, the agent or the property. On eliminating the buyer's claims, the agent is free to move on to the seller's ultimate objective of locating a prospective buyer who is ready, willing and able to acquire the property.

In a declining real estate market, a seller's losses include the price-value difference between the price agreed to by the buyer and the lower value of the property at the time of the buyer's breach. This amount often exceeds the amount of the buyer's deposit when the business cycle slips into recession. The seller may want to consider retaining the purchase agreement in effect to recover all their losses caused by the buyer's breach.

Further, the amount of the deposit or other amount when set out in the purchase agreement as the [ceiling](#) for any seller recovery further limits the amount the seller can recovery from the buyer. [\[See RPI Form 150 §10.8\]](#)

Finally, a buyer's cancellation of escrow and the release of the escrow deposit without also canceling the purchase agreement leaves intact the seller's right to enforce specific performance of the sale or the collection of the remainder of their losses (money and any price-value decline) on the buyer's breach. [CC §1057.3(e)]

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