
Strategies to Protect Developers Against Defaulting Buyers

In these uncertain economic times, many developers are facing an unprecedented number of defaulting buyers. A well-designed cancellation program can help developers recover some of the damages from these lost sales. It can also help to maintain a good reputation and relationship with potential buyers who may return in the future when the market shifts. The following factors should be considered when crafting a cancellation program that will maximize a developer's recovery and minimize any negative impact on goodwill.

I. Assess Whether Your Sales Package Offers the Best in Developer Protection.

The first step toward a strong buyer default strategy is a strong sales package and careful compliance with notice requirements.

- **Purchase Agreement.** Strengthen the enforceability of your purchase agreement and ensure that it has all the required liquidated damage language under the California Civil Code. Are your disclosures reasonably thorough and complete regarding the project and the surrounding community? If not, defaulting buyers may attempt to rely on lack of disclosure to excuse their failure to perform.
- **Notice Requirements.** Have you created a form 20-day notice letter to buyers who have failed to close escrow, and established a tracking system to ensure that they respond within the deadline? To comply with the California Civil Code, these letters must be sent in a way that provides a return receipt to prove buyer received the notice.

II. Negotiations and Strategy.

When a buyer default occurs, consider the following:

- **Retaining Liquidated Damages.** Under California Civil Code Section 1675, a developer will always be "presumed reasonable" in retaining three percent (3%) of the purchase price as liquidated damages (and for units with a purchase price of \$1,000,000 or more that meet certain other criteria, six percent (6%) of the purchase price will be presumed reasonable). When damages are "presumed reasonable," it shifts the burden of proof to the party claiming that they are unreasonable. Depending on the number of defaults, the amount of the deposits and the sales prices at a particular project, this can equate to millions of dollars at stake.
- **Recovering Actual Damages.** If deposits larger than the percentage "presumed reasonable" under the statute were collected, the developer will want to weigh the costs and risks associated with proving up those damages at an arbitration against the amount that it may be able to recover. California Civil Code Section 1675(e) states that the following factors should be considered in determining whether a deposit amount is "reasonable" as liquidated damages: (a) the circumstances existing at the time the contract was made, and (b) the price and other terms and circumstances of any subsequent sale or contract to sell and purchase the same property, if the re-sale or contract is made within six months of the buyer's default. For example, if the Unit has not resold within six months from the date of buyer's default or if resale occurs at a substantially lower purchase price, the developer may show damages in excess of the percentage of the purchase price "presumed reasonable." However, a developer should also consider factors such as the time and cost of arbitration, the positive and negative messages sent by pursuing the matter, and whether an attorney's fees provision exists.

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- **Accounting.** If the deposit amount being claimed by developer exceeds a certain percentage of the sales price, an “accounting” may be required under Cal. Civ. Code Section 1675(f)(1) and (g)(1). This “accounting” determines the amount of the developer’s losses resulting from the buyer’s default by considering the costs and revenues related to the construction and sale of the property and any delay caused by the buyer’s default.
- **Intent to Occupy.** Consider whether you have any evidence that buyer did not intend, at the time of purchase, to use the home as his or her “residence.” In such a situation, the consumer protection provisions of California Civil Code Section 1675 do not apply, and the entire deposit is presumed reasonable as liquidated damages so long as the amount was “reasonable at the time of contract.”
- **Creative Alternatives.** The developer might want to consider creative solutions such as allowing the buyer to transfer their deposit to purchase a less expensive unit, or offering a program for lease-options that would allow the buyer to live in the unit, allow the developer to collect rent, and allow the buyer to close escrow at a later date. Any programs such as this should be designed so that the developer does not lose any of its rights based on the buyer’s original default under the purchase agreement, including provisions for the disbursement of deposit money if there is a further default by the buyer, and may also require review by the Department of Real Estate.
- **Settlement Agreement and Escrow Instructions.** Once you reach an agreement with a defaulted buyer, it is key to have a strong settlement agreement and release to effectively resolve the dispute. The developer should consider including a confidentiality provision in the settlement agreement.

Please contact any of the attorneys listed below to discuss any questions you have regarding buyer defaults in your project or to formulate a successful strategy for dealing with future defaults.

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