CALIFORNIA ASSOCIATION OF REALTORS®

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Liquidated Damages and Deposit Disputes

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Apr. 7, 2016 (revised)

Introduction

When a buyer breaches a purchase agreement, a seller may be entitled to damages. How much will typically depend on whether the liquidated damages provision was initialed and thereby made part of the contract. If it was, then the seller will likely be entitled to the amount of the deposit. If not, then the seller will have to prove their losses.

This legal memorandum addresses liquidated damages clauses which award damages only to a seller in the event of a buyer's breach of a real property purchase contract. This is the type used in the C.A.R. purchase agreements and is the most common type of liquidated damages clause used in the real estate industry.

Liquidated damages clauses awarding damages to a buyer in the event of a seller's breach, in leases, or in other types of contracts may be subject to different rules, and generally should not be used without first consulting with an attorney.

Liquidated Damages - Basics

Q 1. ***What is a liquidated damages provision?***

A A Liquidated damages provision is an agreement in advance that in the event the buyer breaches contract, the buyer will owe a specified amount of money. For example, if the agreed deposit amount is $5,000 which is placed in escrow and the liquidated damages provision is initialed by both buyer and seller, then if the buyer breaches contract, the seller will be entitled to $5000.

It does not matter whether the seller has incurred an actual loss that is either more or less than $5000. That is the whole purpose of the provision – to fix the amount damages in advance so that it is not necessary to prove the actual loss.

It is possible to create a liquidated damages provision awarding damages to a buyer in the event of a seller's breach. However, most residential property contracts, including the C.A.R. purchase contracts, generally do not contain this type of provision. Additionally, such a provision in real property contracts, in leases, or in other types of contracts may be subject to different rules, and generally should not be used without first consulting with an attorney.

Q 2. ***What is the advantage of a liquidated damages provision to the buyer?***

A For the buyer, the main advantage of the liquidated damages provision is certainty. If the clause is part of the contract, the buyer knows in advance the maximum amount of money that he or she will owe to the seller in the event of a breach. If the amount of the deposit is $5000 then that is the maximum the buyer will owe. A low deposit amount will, therefore, usually work to the advantage of the buyer.

Q 3. ***What is the advantage of a liquidated damages provision to the seller?***

A As for the seller, the advantage is similar in that it provides the seller with certainty as to what the buyer's liability will be in case of breach. If the deposit is $5,000, the seller is, in most circumstances, assured of being legally entitled to the full deposit of $5,000 in the event of a buyer breach. (But see questions 14 - 19 for situations in which the buyer may challenge the liquidated damages provision).

Another important advantage to the seller is that the seller need not prove damages in court because the amount of the damages has been agreed to in advance. Proving the seller's actual loss can be fairly complicated, but with the liquidated damages provision in place, the seller need only show that the buyer was in breach of contract.

Q 4. ***Could a seller collect monetary damages from a buyer for breaching a real property purchase contract that did not contain a liquidated damages clause?***

A Yes. The fact that a real property purchase contract does not contain a liquidated damages clause does not mean that a buyer could escape liability for failing to perform. It simply means that the amount of damages the seller could recover would not have been pre-negotiated, and therefore the seller will have to establish, in court or arbitration, the amount of his or her actual monetary injury. Establishing the financial loss resulting from a breach of contract can be a complex and expensive process, and may require the presentation of evidence in court or arbitration. Generally, a seller will need the assistance of an attorney to properly calculate the actual damages he or she has sustained in a failed real estate transaction.

Q 5. ***Given the benefits of a liquidated damages provision, shouldn't buyers and sellers always insist on one?***

ANot necessarily. A liquidated damages provision is an estimate of the damages a seller might be entitled to in the event a buyer were to breach a contract. This estimate could differ significantly from the actual damages ultimately suffered by a seller.

For example, assume that a buyer's deposit was $5,000, but the actual financial loss to the seller when that buyer wrongfully failed to perform ended up being $10,000. In this case, a liquidated damages clause fixing the seller's recovery at $5,000 will likely preclude the seller from recovering the full actual loss. Here, the seller might regret having agreed to liquidated damages. On the other hand, assume that the actual financial loss to the seller ended up being only $1,000. In this case, a liquidated damages clause could result in the buyer losing more than the seller's actual damages, and the buyer might regret having agreed to liquidated damages.

Q 6. ***Should a REALTOR® advise a client whether or not to agree to a liquidated damages***

provision?

A No. As illustrated in the previous question, the decision to agree or not agree to a liquidated damages provision may depend on a combination of legal and economic factors, along with a client's own personal concerns. Though many REALTORS®' clients decide to agree to liquidated damages clauses, a client with serious questions regarding such a clause should consider discussing the matter with an attorney if needed.

Agreeing to Liquidated Damages

Q 7. ***How do the buyer and seller agree to the liquidated damages provision?***

A The buyer and seller must both initial the liquidated damages provision. If only one or the other initial this provision then it will not be a part of the contract unless it is specifically referenced for inclusion on a counter offer.

Q 8.***What happens if there is no agreement on the liquidated damages provision?***

A Assuming there is a binding agreement without a liquidated damage provision, then this simply means that in the event of breach by the buyer, the seller will be required to prove their actual damages in order to win a judgment in court. There will be no automatic presumption that the seller is entitled to the deposit amount.

Q 9. ***What would happen if fewer than all parties initialed a liquidated damages provision?***

A Because a liquidated damages provision is optional, it is important that contracting parties clearly indicate in their contract whether or not they intend to be bound by a liquidated damages clause. If some, but not all, parties initial a liquidated damages clause, it can be difficult to determine whether they intended to be bound by the clause, or whether they intended to enter into a contract at all. Some purchase contracts attempt to prevent such ambiguities by specifically stating that the contract is not binding until all parties reach agreement to initial or not initial the liquidated damages clause. C.A.R.'s purchase agreements typically include language to this effect.

In the absence of such contractual language, the enforceability of the clause would be subject to interpretation by the courts. In one case, a California appellate court ruled that a liquidated damages clause, though not properly executed, was enforceable or voidable at the buyer’s option, but not the seller's option. Various factors can affect the outcome of lawsuits, making it possible for different courts to reach different conclusions on similar facts. For this reason, contracting parties should not leave any ambiguities and ideally all parties should agree to either have or not have a liquidated damages clause as part of the contract. If your client wishes to proceed if when it is unclear, you should advise them to speak to an attorney about the possible consequences. Guthman v. Moss, 150 Cal. App. 3d 501 (1984). Also see Allen v. Smith, (94 Cal. App. 4th 1270 (2002).

The Amount of the Liquidated Damages Provision in the RPA-CA

Q 10. ***How much is the liquidated damage?***

A The C.A.R. purchase agreement says that it is the amount of the deposit “actually paid.” Thus, if the agreed upon amount of the deposit was $10,000 but the buyer only puts $5,000 into escrow, then

the liquidated damages amount will be $5,000.

Q 11. ***Is the liquidated damages amount always 3%?***

A No. It's the amount actually paid into escrow. However, where the buyer will take occupancy of a residential dwelling up to four units, then per the terms of the RPA-CA the liquidated damage amount can be no more than 3%. Thus, even though the deposit actually placed into escrow might be $50,000, on a $1 million property the liquidated damages will be no more $30,000. (Paragraph 21B of the RPA-CA)

Also if less than 3% of the purchase price is the agreed amount of the deposit and that is placed into escrow, the seller is still limited to collecting in damages only the agreed amount of the deposit and cannot later try to get additional funds. So if 3% of the purchase price would have been $10,000 but in the contract the parties agreed to a $3000.00 deposit, the seller is limited to the $3,000.00 even if $10,000 is placed into escrow.

Q 12. ***Is it possible to have a liquidated damage provision greater than 3% in residential sales?***

A It's possible. However, where the buyer is take occupancy on a 1- 4 residential sale, the RPA-CA does not permit this by the terms of the contract. Paragraph 21B of the RPA-CA states that the liquidated damages will be no more than 3% of the purchase price. If the buyer is not taking occupancy or the property is not residential 1 – 4 then the liquidated damage amount may be more than 3%.

Q 13. ***How may the liquidated damages provision be increased?***

A The buyer and seller should both sign a Receipt for Increased Deposit/Liquidated Damages (C.A.R. Form RID) and the buyer must then place the increased amount into escrow.

If the RID form is never signed but there appears to be an agreement in writing to increase the liquidated damages and the amount is then placed into escrow, a judge may have discretion to award the full amount of the agreed deposit to the seller; but of course, this possibility should never be relied upon, and the best practice is to follow the rules precisely and use the RID form.

Challenging the Liquidated Damage Provision

Q 14. ***If the liquidated damages actually paid is $5000, what happens if the seller incurs an actual loss that is much greater than $5000?***

AThe seller will likely be unable to claim more than $5000. That was the purpose of the liquidated damages provision – to agree in advance as to what the buyer will pay in damages in the event of breach. Most judges will be very reluctant to disregard this provision.

Q 15. ***Under what circumstances will a judge disregard the liquidated damages provision and permit the seller to attempt to prove actual loss?***

A Only in rare circumstances. In general if the property is a residential dwelling of no more than four

units and the buyer will take occupancy, the law does not permit the seller to establish the unreasonableness of the liquidated damages as too low (Compare Civil Code subsections 1675(c) and 1675 (d)). Perhaps if the buyer placed no money at all into escrow, then a judge might ignore the literal language of the law and disregard the liquidated damages provision, thereby, permitting the seller to prove actual damages.

Q 16. *How may a buyer challenge a liquidated damages provision?*

A Where the property contains no more than four dwelling units and the buyer intends to occupy it, then the buyer may challenge the liquidated damages provision by establishing that the amount actually paid is unreasonable. (Civil Code Section 1675(c)). In general, the reasonableness of the amount actually paid as liquidated damages is determined by taking into account both 1) the circumstances existing at the time the contract was made and 2) the price and other terms of any subsequent sale or contract to sell the same property if the sale or contact is made within six months of the buyer's default.

The most common scenario where a buyer may have a greater likelihood of success is a very hot market where a seller resells the property quickly and for more money. In such a scenario it could be argued that the buyer's breach actually benefitted the seller and a judge may be unwilling to give the seller both the benefit of the increased price received from the sale of the home to a new buyer and the full deposit of the buyer's whose breach actually benefitted the seller.

Thus, it is clear that a residential buyer will have an easier time of challenging the liquidated damages provision than a seller. Nonetheless, most of the time, judges will be reluctant to disregard an agreed upon liquidated damages provision even where it is the buyer that is challenging it.

Q 17. *In property sales other than residential property up to four dwelling units where the buyer is to take occupancy under what circumstances may a judge may disregard the liquidated damage provision?*

A For other types of properties, a liquidated damage provision is valid unless the party seeking to invalidate the provision establishes that the provision was unreasonable under the circumstances existing at the time the contract was entered into. (Civil Code Section 1671(b)). This would be the same rule for both a buyer and seller.

Q 18. *Are there any limits on how much money a seller can safely collect from a buyer as liquidated damages?*

A To be deemed valid, a liquidated damages clause in a real property purchase contract liquidating damages to a seller should reflect a "reasonable estimate" of the actual loss that the seller would suffer in the event of a buyer's breach. While the "reasonableness" of a liquidated damages clause depends on many factors, the basic objective of the law is that sellers not use liquidated damages clauses to "punish" buyers unfairly, or to make a large profit over and above their actual financial injury. Cal. Civ. Code §§ 1671(b), 1676, 3275. Also see Ridgley v. Topa Thrift and Loan Ass'n, 17 Cal. 4th 970 (1998).

An additional, more specific, rule applies if the real property being sold is a dwelling containing not more than four residential units, one of which the buyer intends, at the time the purchase contract is made, to occupy as a residence. In these types of transactions, a liquidated damages clause

identifying all or part of a buyer's deposit as liquidated damages will be presumed reasonable if the amount actually paid pursuant to the clause does not exceed more than 3% of the property's selling price. A party challenging the validity of such a clause (typically the buyer) would have the burden of proving that the amount identified is unreasonable.

Conversely, if the amount actually paid exceeds 3% of the selling price, the liquidated damages clause is presumed to be unreasonable, and the party seeking the damages (typically the seller) might have to prove that the amount identified is reasonable. (However, as already stated, the C.A.R. purchase agreements themselves do not permit a liquidated damages amount of greater than 3% on residential 1 to 4 property will the buyer will take occupancy). Cal. Civ. Code § 1675.

For sales of subdivision interests regulated by California's Subdivided Lands Act, the law specifically limits the liquidated damages a subdivider can collect from a defaulting buyer to the amount of purchase money advanced by the buyer toward the purchase of the property.10 Cal. Code Regs. §§ 2791(a), (c)(1).

Q 19. *Does a liquidated damages clause automatically entitle the seller to the buyer's deposit if a transaction does not close?*

A No. A liquidated damages clause only determines the amount of money a seller can recover from a buyer, and then only if the seller can prove that the buyer breached the contract. A buyer may fail to close a transaction for a variety of acceptable reasons (e.g., where the buyer's obligation to purchase was contingent on the buyer obtaining financing, and the buyer could not reasonably obtain financing). To recover liquidated damages, the seller generally must prove in court or arbitration that the buyer's failure to close the transaction was a breach.

A limited exception exists for certain sales of subdivision interests regulated by California's Subdivided Lands Act. A subdivider's contract may include a procedure whereby an escrow holder is authorized to release a buyer's deposit to the subdivider pursuant to a liquidated damages clause if the subdivider provides a specified notice to the escrow holder and buyer declaring the buyer to be in default, and the buyer does not object to the subdivider's notice. 10 Cal. Code Regs. § 2791(c)(4).

Non-refundable Deposits

Q 20. *Is a "nonrefundable deposit" clause the same as a liquidated damages clause?*

A No. A nonrefundable deposit clause typically provides that the buyer must forfeit his or her deposit to the seller even if the buyer has a valid reason for not closing the transaction. By comparison, a liquidated damages clause entitles a seller to the buyer's deposit only if the buyer breaches the contract (see Questions 3 and 19). It can be difficult to draft an enforceable nonrefundable deposit clause; only an attorney should attempt this.

Q 21. *Can the parties agree in advance that the buyer will pay a non-refundable deposit in the event of breach?*

A Generally no. The law does not permit contracts to impose penalties or forfeitures, including a non-refundable deposit, for breach absent gross negligence, willful or fraudulent breach. (Civil Code Section 3275). In general, judges are reluctant to penalty or forfeiture clauses where they bear no realistic relationship to the actual damages incurred. Moreover, courts have found that any provision in a contract by which money or property would be forfeited "without any regard to the actual damage

suffered would be an unenforceable penalty." (Freedman v. The Rector, Wardens & Vestrymen of St. Matthias Parish (1951)).

Additionally, the RPA-CA's language does not permit such clauses.. under paragraph 21A of the RPA-CA, any added clause specifying a remedy for a buyer breach such as a non-refundable deposit or a forfeiture of the deposit will be invalid if the added clause does not independently comply with the Civil Code's liquidated damage rules.

Q 22. *Can a seller ask the deposit to be released before close as a condition of accepting an extension?*

A Yes. The most common circumstance in which a deposit is released is pursuant to a negotiation for an extension of escrow. At that time, sellers who want to retain the buyer's deposit in the event of default may offer an extension. At the same time, it is recommended that the buyer be required to remove all contingencies. The deposit released should be the amount that was in fact placed into escrow pursuant to the purchase agreement and should be no more than 3%.

Do not provide assurances that the seller will retain the deposit under all circumstances even if released. Where the seller breaches contract, where the amount is "excessive" in relation to the amount of the seller's actual loss, or where the seller resells the property and thus reduces their loss, it may still be possible for the buyer to attempt to get the deposit back. So a release of the deposit to the seller is nothing more than that, it does not guarantee that the seller will in fact be able to retain that deposit in all circumstances. Timney v. Lin (2003) 106 Cal. App. 4th 1121 (This case denied a liquidated damage amount that was part of a court approved settlement); Horowitz v Noble (1978) 79 Cal.Appl 3d 120) (This case upheld payment of additional money as consideration for extending escrow but the parties were deemed "sophisticated.")

Legal Requirements

Q 23. *Does a liquidated damages clause have to be in any special format?*

A To be deemed valid, a liquidated damages clause in a real property purchase contract liquidating damages to a seller should conform to the following formatting requirements:

- If the contract is preprinted, the clause must be in at least 10-point bold type, or contrasting red print in at least 8-point bold type.
- The clause must be separately signed by each party to the contract.

All liquidated damages clauses in C.A.R.'s purchase agreements conform to all applicable formatting requirements.

Cal. Civ. Code §§ 1676, 1677

Q 24. *Why does the contract state that the amount of the liquidated damages is the "deposit actually paid?"*

A For residential 1 – 4 sales in which the buyer will take occupancy, Civil Code Section1675 only permits a liquidated damage to the extent that it is actually paid. So the contract is merely reflecting the law.

Disputes

Q 25. *If a buyer and seller disagree as to whether the buyer breached a contract, can the seller refuse to release the buyer's funds being held in escrow?*

A Yes. Generally, a prudent seller will instruct an escrow holder not to release escrowed funds to a buyer only if he or she has a good faith belief that the buyer breached the contract. Without such good faith belief, the seller runs the risk that the buyer will institute a lawsuit or arbitration, not just to recover the escrowed funds, but also to recover penalties or damages from the seller.

If the subject property is real property containing one to four residential units, one of which, at the time the escrow was created, the buyer intended to occupy as his or her residence, an additional, more specific rule applies. This rule provides that, unless the seller is withholding the buyer's funds pursuant to a good faith dispute with the buyer, the seller's failure to authorize the release of the funds within 30 days following a written demand from the buyer may subject the seller to a penalty equal to three times the amount of the undisputed funds (but not less than $100 nor more than $1,000), in addition to reasonable attorney's fees. A "good faith dispute" is defined, in part, as a reasonable belief of one's legal entitlement to withhold the escrowed funds. Cal. Civ. Code § 1057.3.

If the property is part of a subdivision regulated by California's Subdivided Lands Act and the escrow does not close on or before the mutually agreed closing date, any portion of the buyer's deposit(s) not being claimed as liquidated damages by the subdivider must be returned to the buyer within 15 days after the agreed closing date. This obligation must be stated specifically in the subdivider's contract. 10 Cal. Code Regs. § 2791(a).

Q 26. *If a buyer and seller disagree as to whether the buyer breached a contract, can an escrow holder honor a buyer's request to release his or her funds?*

A Once a buyer and seller have properly executed escrow instructions to an escrow holder, the escrow holder generally will not release funds to a buyer over a seller's objection unless so ordered pursuant to a court order after litigation or an arbitration award after arbitration proceedings. The RPA-CA has a specific provision addressing this. Paragraph 14H states, **"…release of funds will require mutual Signed release instructions from the Parties, judicial decision or arbitration award."** But there is one exception. See the next question.

Q 27. *Is there a specific provision in the RPA-CA that would authorize release of a buyer's deposit without litigation or arbitration proceedings or mutual signed instructions?*

A Yes. The RPA-CA has a special procedure for doing just this. Under paragraph 14H a seller or buyer may make a written demand to the escrow for the deposit using C.A.R. Form BDRD or SDRD "Buyer (or Seller) Demand for Release of Deposit"). The escrow is then to deliver notice of the demand to the other party. If, within 10 days after the notice, the other party does not object to the demand, the escrow is required to disburse the deposit.

Q 28. *Despite the procedure above, can the escrow holder still require mutual signed instructions, judicial decision or arbitration award to release the deposit?*

A Even though the RPA-CA provides for a procedure to release the deposit absent litigation,

arbitration or mutual signed instruction, escrows will sometimes refuse to abide by the above procedure.

Q 29. ***If the escrow follows the procedure as stated in the prior questions to release the deposit, what is their liability?***

A The RPA-CA states that if the escrow releases the deposit by following the above procedures then the buyer and seller are deemed to have released the escrow from any and all claims or liability related to the disbursal of the deposit.

Q 30. ***What if the escrow holder refuses to release the deposit?***

A Then the seller (or buyer) will have to either litigate or arbitrate to get the deposit released.

Q 31. ***The buyer (or seller) won't release the deposit, is there a sample letter that demands its release?***

A Yes. There are sample letters for both the buyer and the seller. For buyers there is the Sample Letter "Demand for Deposit for Contingency Cancellation" (Letter BDD). And for the seller there is the Sample Letter "Demand for Deposit Buyer Failure to Close" (Letter SDD). Both letters demand the release of deposit, provide a deadline, and explain that a $1000 penalty may be awarded in addition to the deposit. Both letters additionally fulfill the small claims court requirement that a demand be made for the amount in dispute before filling a complaint.

The Sample Letters can be found in ZIPform. Under "forms," go to the "Select Library" drop down menu and choose CAR Sample Letters. All of the letters can then be accessed.

Q 32. ***Does a seller (or buyer) have to always mediate or, when the parties agreed to, arbitrate a dispute over the deposit.***

A No. The RPA-CA excludes the requirement for both mediation and arbitration where the seller (or buyer) brings a matter within the jurisdiction of small claims court.

Q 33. ***I would like to provide my buyer (or seller) with information on how to argue their case in small claims court. Does C.A.R. have any information on this?***

A Absolutely. C.A.R. has produced the Small Claims Court Assistance Manual for REALTORS and Their Clients.

The purpose of this manual is to help REALTORS® and their clients prepare for and present a case in small claims court. It is not a guarantee that you or your client will be successful in bringing or defending a case but rather a source of pertinent information that should enable the user to make a more knowledgeable and effective presentation

Q 34. ***If a buyer and seller agree to a liquidated damages clause, are the seller's remedies limited to pursuing liquidated damages, or could the seller pursue other legal remedies, such as specific performance?***

A Monetary damages represent only one type of legal remedy available to a seller. There are other types of legal remedies that a seller can pursue when a buyer breaches a contract, including specific performance (a type of legal action to compel a party to a contract to complete his or her performance under the contract). Typically, a liquidated damages clause only limits the amount of monetary damages a seller can collect as compensation for a buyer's breach of contract; it does not by itself prevent the seller from pursuing an action for specific performance. Cal. Civ. Code § 1680.

For sales of subdivision interests regulated by California's Subdivided Lands Act, the California Department of Real Estate (DRE) publishes a sample liquidated damages clause which includes language limiting the subdivider's remedies to liquidated damages. Because the DRE enforces the Subdivided Lands Act, the provisions of its sample liquidated damages clause may provide subdividers with guidance in drafting enforceable liquidated damages clauses.(See page 77 of the California Department of Real Estate Subdivision Public Report Application Guide, Rev. 2011)

Q 35. *The previous question suggests that sellers can often choose from amongst various legal remedies when a buyer defaults. Which is the best legal remedy?*

A Choosing an appropriate legal remedy usually depends on many different factors, including the extent of one's injury, the complexity of pursuing a particular remedy, and potential legal costs. For example, an action for specific performance, to compel a buyer to complete his or her contractual obligations, is generally much more complex than an action to recover liquidated damages, may be more difficult to win, and may be more costly than an action to recover liquidated damages. A seller who is interested in exploring the benefits and detriments associated with different legal remedies generally should consult an attorney.

Also, specific performance against a buyer in a typical residential transaction is very hard and often not worth the legal cost since in most cases buyers need loans to purchase the property. For example, if the seller is successful in making the case for the buyer to specifically perform, if the buyer cannot obtain a loan the buyer still would not be able to purchase the home.

Q 36. *If a buyer makes more than one deposit pursuant to a purchase contract, will a liquidated damages clause entitle a seller to all of the buyer's deposits if the buyer defaults?*

A Not necessarily. If the real property being sold is a dwelling containing not more than four residential units, one of which the buyer intends, at the time the purchase contract is made, to occupy as a residence, each payment that is to be part of the liquidated damages to the seller must be supported by a separately signed or initialed, properly formatted liquidated damages clause. In addition, if the total of all such deposits exceeded 3% of the purchase price, as discussed in the question 11, the seller could be limited to that #5 even if more is deposited. The C.A.R. form Receipt for Increased Deposit/Liquidated Damages (C.A.R. Form RID), should be signed at the time an additional deposit is made during escrow in order to make any additional payments part of the liquidated damages.

Q 37. *Where can I get additional legal information?*

A This legal article is just one of the many legal publications and services offered by C.A.R. to its members. For a complete listing of C.A.R.'s legal products and services, please visit car.org/legal.

Readers who require specific advice should consult an attorney. C.A.R. members requiring legal

assistance may contact C.A.R.'s Member Legal Hotline at (213) 739-8282, Monday through Friday, 9 a.m. to 6 p.m. and Saturday, 10 a.m. to 2 p.m. C.A.R. members who are broker-owners, office managers, or Designated REALTORS® may contact the Member Legal Hotline at (213) 739-8350 to receive expedited service. Members may also submit online requests to speak with an attorney on the Member Legal Hotline by going to http://www.car.org/legal/legal-hotline-access/. Written correspondence should be addressed to:

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