COMMONWEALTH OF KENTUCKY
SUPREME COURT OF KENTUCKY
2011-SC-000415-D
(2010-CA-001544)

RAMESH PATEL — **APPELLANT**

VS. **APPEAL FROM MONTGOMERY CIRCUIT COURT**
CIVIL ACTION NO. 2007-CI-90109

TUTTLE PROPERTIES, LLC, et al. — **APPELLEES**

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BRIEF FOR APPELLANT

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Submitted by:

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CERTIFICATE REQUIRED BY CR 76.12(6)

This is to certify that a true copy of the Brief for Appellant was sent by first-class mail to Sam Givens, Clerk, Kentucky Court of Appeals, 360 Democrat Drive, Frankfort, Kentucky 40601-9230; Honorable Beth Lewis Maze, Montgomery Circuit Judge, P.O. Box 1267, Mt. Sterling, Kentucky 40353; and Jesse R. Hodgson, Esq., White Peck Carrington, LLP, Attorneys for Appellees, P.O. Box 950, Mt. Sterling, Kentucky 40353-0950, this 16 day of July, 2012.

M. ALEX ROWADY, ESQ.

INTRODUCTION

This case involves an appeal from a summary judgment approving the vendors' retention of the vendee's $125,000.00 earnest money deposit after the vendee was unable to obtain financing needed to close a $450,000.00 commercial real estate transaction.

STATEMENT CONCERNING ORAL ARGUMENT

Appellant desires oral argument to provide the Court with an opportunity for further inquiry into this important question of law. The principle facts before the Court are largely uncontroverted yet the application of law to those facts not only allocates a large sum of money between these parties but also may serve to clarify the Court's views on the essential differences between a proper liquidated damages clause and an unenforceable penalty.

STATEMENT OF POINTS AND AUTHORITIES

STATEMENT OF THE CASE

On October 12, 2006, Appellant Ramesh Patel (hereinafter "Patel") entered into a written contract to purchase a convenience store and associated real estate in Mt. Sterling, Kentucky from Appellees Tuttle Properties, LLC (hereinafter "Tuttle") and BT's Quick Mart, LLC (hereinafter "Quick Mart") (collectively "Appellees"). The parties' contract--styled Asset Purchase and Sale Agreement (hereinafter "Agreement")--stated the transaction was to close within 120 days after the date of the Agreement. Upon signing the Agreement, Patel placed the sum of $125,000.00 into the escrow account of the Appellees' attorneys to be applied against the total purchase price of $450,000.00 at closing. Paragraph three of the Agreement detailed the purpose of Patel's escrow payment as follows:

> 3. Earnest Money Deposit. As evidence of good faith binding this Agreement, [Patel] has, simultaneously with the execution of this Agreement, deposited with White Peck Carrington, LLP, as escrow agent for [Tuttle], Quick Mart and [Patel], earnest money in the sum of $125,000.00, receipt of which is hereby acknowledged by [Tuttle] and Quick Mart, the same to be applied on the total purchase price due and payable hereunder at closing, or refunded to [Patel] if the Closing does not take place pursuant to the terms, conditions and provisions of this Agreement due to not fault of, or breech [sic] hereunder by, [Patel].

(Record, p. 38)

Shortly after execution of the Agreement, the parties decided Patel could begin operating the convenience store prior to closing and a lease agreement to that effect was signed by Patel and Tuttle on October 18, 2006. That same date, the parties executed an additional document modifying the October 12, 2006 Agreement titled First Amendment to Asset Purchase and Sale Agreement (hereinafter "First Amendment"). Among other things, the First Amendment

permitted Patel's $125,000.00 deposit to be withdrawn from escrow for payment directly to Tuttle, which occurred on October 19, 2006. **Nevertheless, the original purpose of Patel's escrow payment remained the same as evidenced by the following language contained in the First Amendment:**

> In consideration of the mutual benefits to be derived therefrom by the parties hereto, Tuttle, Quick Mart and [Patel] agree that the entirety of the $125,000.00 currently held by White Peck Carrington, LLP, Mount Sterling, Kentucky, as Escrow Agent for Tuttle, Quick Mart and [Patel] under the above referenced [October 12, 2006] Agreement, shall be transferred and paid this date by White Peck Carrington, LLP, as Escrow Agent aforesaid, to Tuttle *as the earnest money deposit under the Agreement, the same to be applied on the total purchase price due and payable under the Agreement at Closing, or refunded to [Patel] if the Closing does not take place pursuant to the terms, conditions and provisions of the Agreement due to no fault of, or breech* [sic] *under the Agreement by, [Patel]*. (emphasis added)

(Record, pp. 38-9)

Likewise, the First Amendment did not modify the time allotted to close the deal (120 days, which would have expired in February of 2007); yet despite the above-referenced term of the First Amendment, Tuttle spent the entire $125,000.00 **before the end of 2006.** (See Deposition of Cecil Tuttle, pp. 10-13) This occurred even though Appellees knew such funds, whether placed in the attorneys' trust account or in Tuttle's hands, always retained their character as an escrow deposit. (See Deposition of Brian Tuttle, p. 31)

Ultimately, Patel was unsuccessful in obtaining the necessary financing to complete the transaction. Appellees then retook possession of the real estate but refused to refund any of Patel's escrow deposit. (See Deposition of Cecil Tuttle, p. 19) Their decision to keep the money

was upheld in a summary judgment rendered by the Montgomery Circuit Court and thereafter affirmed by a two-to-one majority of the Kentucky Court of Appeals.

ARGUMENT

I. This Court is not required to give deference to the trial court upon review of its summary judgment. (Preserved for review by timely Notice of Appeal and Motion for Discretionary Review)

The Montgomery Circuit Court allowed Appellees to keep Patel's entire $125,000.00 earnest money deposit by granting summary judgment in their favor. Because factual findings are not at issue when cases are resolved by summary judgment, an appellate court is not required to show deference to the trial court when reviewing its decision. Goldsmith v. Allied Building Components, Inc., 833 S.W.2d 378, 381(Ky. 1992).

II. The Court of Appeals should have reviewed the circuit court's ruling to determine whether the earnest money clauses constituted a proper liquidated damages provision. (Preserved for review by timely Notice of Appeal and Motion for Discretionary Review)

The central issue in this dispute is whether the earnest money deposit constitutes an appropriate amount of liquidated damages in the event of breach or, instead, is an unenforceable penalty? The answer to this question should determine the outcome of this appeal.

Somehow, a majority of the Court of Appeals did not view the case as turning on the issue of liquidated damages versus unenforceable penalty. In its analysis, the majority dismissed the would-be liquidated damages inquiry thusly: "[w]hile Patel argues the Agreement did not contain a valid liquidated damages clause under United Services Auto. Ass'n v. ADT Sec. Services, Inc., 241 S.W.3d 335(Ky. App. 2006), we see no reason to address that issue given the express language of the Agreement". (Court of Appeals Opinion, pp. 5-6) Such a view seems at

odds with prior decisions of this Court and of the Court of Appeals itself.

In Furlow v. Sturgeon, 426 S.W.2d 485(Ky. 1969), the predecessor to this Court held that a real estate vendor was entitled to prove damages resulting from the loss of bargain after the vendee failed to purchase the land in question. Like Patel, the vendee in Furlow had paid an earnest money deposit upon execution of the contract of sale which (unlike Patel) was ordered by the lower court to be returned to the vendee when the sale did not consummate. The appellate panel reversed, but rather than simply awarding the escrow to the vendor, it remanded to allow the vendor an opportunity to prove damages caused by the vendee's breach. Furlow, 436 S.W.2d at 487. While there was no mention of liquidated damages in the opinion, neither was there an award of the deposit to the vendor as a matter of contract language as occurred here.

The Court of Appeals' decision in the present case is also inconsistent with its own precedent. As in Furlow *supra*, the Court of Appeals has defined a real estate seller's damages caused by the purchaser's nonperformance as the sum of the former's loss of bargain plus consequential damages. Lawson v. Menefee, 132 S.W.3d 890, 895 (Ky. App. 2004). No mention was made in the opinion of an earnest money deposit, but the policy espoused in these types of cases was plainly stated: the courts will not permit a vendor to receive a windfall just because the purchaser breached the contract. Lawson, 132 S.W.3d at 895. By allowing Appellees to keep Patel's earnest money, the courts below have sanctioned such a windfall.

Kentucky courts have traditionally approved the use of contractual provisions establishing an amount of damages upon breach but such clauses have always been subject to judicial scrutiny to determine their fairness and, consequently their enforceability. *See e.g.*, Woodbury v. Turner, Day & Woolworth Mfg. Co., 29 S.W. 295(Ky. 1895); Allison v. Cocke's

Ex'rs, 51 S.W. 593(Ky. 1899)(clause in real estate contract deemed forfeiture; vendor to return purchase money, less actual damages caused by breach). This insistence upon judicial oversight has continued to the present day. *See e.g.*, Mattingly Bridge Co., Inc. v. Holloway & Son Const. Co., 694 S.W.2d 702(Ky. 1985); United Services Auto. Ass'n v. ADT Sec. Services, Inc., 241 S.W.3d 335(Ky. App. 2006). But under the new model created by the Court of Appeals in its affirmance of the Montgomery Circuit Court, the judicial review which has existed for over a century would be replaced by a rule of unquestioned deference to the contract terms regardless of their harshness, fairness to the parties, or even the parties' intent. Surely such a departure from long-established principles cannot be condoned by this Court.

III. The earnest money clauses were an unenforceable penalty. (Preserved for review by timely Notice of Appeal and Motion for Discretionary Review)

Once the earnest money provisions contained in the Agreement and First Amendment are seen for what they are, namely an attempt to set damages for breach, then the analysis which eluded the courts below must be undertaken. In Mattingly Bridge *supra*, this Court adopted the following language of the *Restatement, Second Contracts* § 356(1)(1981) as the standard by which a liquidated damages provision is to be measured:

> Damages for breach by either party may be liquidated in the agreement but only at an amount that is reasonable in the light of the anticipated or actual loss caused by the breach and the difficulties of proof of loss. A term fixing unreasonably large liquidated damages is unenforceable on grounds of public policy as a penalty.

Mattingly Bridge, 694 S.W.2d at 704-05; Man O War Restaurants, Inc. v. Martin, 932 S.W.2d 366, 368(Ky. 1996)(accord). "Anticipated loss" is determined from the vantage point of when the contract is made, while "actual loss" becomes relevant when the breach occurs. Mattingly

Bridge, 694 S.W.2d at 705. The clause must be reasonable at both moments – contract making and breach – otherwise it will be unenforceable. Id. A further restriction on the use of liquidated damages is the requirement that actual damages sustained from a breach would be very difficult to ascertain. Id.

The dissent below correctly points out that the circuit court failed to consider whether the earnest money deposit clauses in the Agreement and First Amendment passed muster under the maxims expressed in Mattingly Bridge and Man O War Restaurants. (Court of Appeals, Dissenting Opinion, p. 9) Had the trial court undertaken the required analysis, it would have found the $125,000.00 sum deposited by Patel to be in the nature of a penalty rather than a proper amount of liquidated damages. Appellee Cecil Tuttle's deposition testimony undermined the notion that Appellees' damages upon breach would be difficult to ascertain. In response to a query about damages, he stated:

> Well, in a convenience store business, the value of the store is based on the volume that the store is doing. If I were going to go buy a store, then, if that store was doing nothing, the value would be not much. But if it's doing a whole lot, then it would be worth more money. At the time they [Patel] took over – and I can document every bit of this with CPA's or whatever – we [Appellees] were averaging, or [Appellee Brian Tuttle] was averaging, $7188 a [day]. When I took over [from Patel], I was averaging $1200 per month. I mean, $1200 a day.

(See Deposition of Cecil Tuttle, p. 19)

As for the reasonableness of the amount ($125,000.00), this Court's predecessor once approved a liquidated damages clause in a real estate purchase and sale agreement where the vendee's deposit represented only five percent of the purchase price. Robert F. Simmons &

Associates v. Urban Renewal and Community Development Agency of Louisville, 497 S.W.2d 705, 706 (Ky. 1973). By contrast, Patel's earnest money deposit constituted nearly 28 percent of the purchase price, more than five times the ratio approved in Robert F. Simmons. Moreover, the evidence in Robert F. Simmons showed that the seller extended the time for submitting financial plans on eight separate occasions which served to tie up the seller's land for a significant period of time, resulting in greater injury to the seller. Id. at 706. Nothing in the proof here demonstrates Appellees made similar allowances to Patel even once. This further supports the view that the $125,000.00 sum was a penalty rather than an appropriate measurement of damages.

IV. The lower courts should have imposed a constructive trust upon Tuttle for Patel's $125,000.00 earnest money deposit. (Preserved for review by timely Notice of Appeal and Motion for Discretionary Review)

As noted above, Tuttle spent the entire earnest money deposit before the closing date arrived even though Appellees knew such funds might need to be returned to Patel if closing did not occur. (See Deposition of Brian Tuttle, p. 31) Under these circumstances, the trial court should have imposed a constructive trust upon Tuttle for the $125,000.00 sum placed in escrow by Patel, or an equivalent amount of money otherwise in Appellees' hands. The constructive trust concept is a century-old remedy in Kentucky; *see* Becker v. Neureth, 149 Ky. 421, 149 S.W. 857(1912); and its continued existence was recently recognized in Terrill v. Estate of Terrill, 217 S.W.3d 858, 860(Ky. App. 2006). As the Terrill court stated, "a constructive trust arises when a person entitled to property is under the equitable duty to convey it to another because he would be unjustly enriched if he were permitted to retain it". Id. (quoting Kaplon v. Chase, 690 S.W.2d 761, 763(Ky. App. 1985))

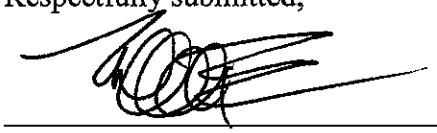
The undisputed facts here demonstrated the need to impose a constructive trust for the

Patel deposit: Appellee Tuttle came into possession of Patel's $125,000.00 earnest money; Tuttle was obligated to safeguard such money; Tuttle admittedly deposed of the funds prior to the closing date set for the parties' transaction; the transaction failed due to Patel's inability to obtain financing; Appellees then regained possession of the convenience store premises; and Tuttle never refunded any of Patel's escrow. In this scenario, equity demanded that Tuttle return Patel's deposit in its entirety.

CONCLUSION

The courts below have erred in allowing Appellees to keep Patel's $125,000.00 escrow deposit after the parties' transaction fell through. The trial court undertook no examination of the earnest money deposit clauses contained in the Agreement and First Amendment to see whether they were appropriate liquidated damages provisions. In fact, the weight of the proof in the record suggested that such clauses were actually a penalty and therefore unenforceable. Furthermore, the trial court should have imposed a constructive trust on the escrow deposit funds while in Tuttle's hands. This Court is requested to reverse the decision of the Court of Appeals and remand this action to the Montgomery Circuit Court with instructions to require Appellees to refund Patel's escrow deposit in its entirety.

Respectfully submitted,



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APPENDIX

1. Kentucky Court of Appeals Opinion Affirming

2. Order and Summary Judgment of Montgomery Circuit Court (Record, pp. 78-9)