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Liquidated Damages in Oregon Commercial Real Estate Transactions

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As part of the national survey of state laws pertaining to the analysis and enforcement of liquidated damages clauses in commercial real estate transactions being conducted by the Acquisitions Committee of the American College of Real Estate Lawyers, this Article examines the principal Oregon judicial decisions relevant to the enforcement of such clauses and some selected issues presented by the ACREL Acquisitions Committee for inquiry.

Illingworth v. Bushong, 688 P2d 379 (Or 1984) (disapproved on other grounds by DiTommaso Realty, Inc. v. Moak Motorcycles, Inc., 785 P2d 343 [Or 1990]; a case involving payment of a real estate commission in which the court ruled that the first step in any analysis of a purported liquidated damages clause is to determine whether it is in fact a liquidated damages clause), is the leading case in Oregon pertaining to the validity of liquidated damages clauses. The prospective purchaser in the Illingworth matter challenged the validity of a purchase agreement clause which provided that the earnest money in the amount of $50,000 would be forfeited to the seller as liquidated damages, if the seller chose to terminate the contract upon breach by the purchaser. The purchase price for the property was the sum of $490,000. The contract was terminated on December 13, 1978, by reason of the failure of the purchaser to close, the seller retained the earnest money and the seller subsequently sold the property for the contract price to a third party on January 25, 1979. 688 P2d at 380-381.

The trial court found that the seller had suffered damages in the amount of $6,500 and ruled that the purchaser was entitled to a judgment for the balance of the earnest money, effectively concluding that the stipulated damage amount constituted a penalty. 688 P2d at 381. On appeal, the Oregon Court of Appeals upheld the trial court decision, finding that there was ample evidence to support a determination that the liquidated damages clause was not enforceable because the amount stipulated ($50,000) was arbitrarily chosen as roughly 10% of the price with no effort undertaken to calculate anticipated damages and the amount of the liquidated damages was disproportionate to the amount of actual damages suffered by the seller. Illingworth v. Bushong, 656 P2d 370, 373 (Or App 1982).

The Oregon Supreme Court accepted the petition for review of the Court of Appeals decision largely because of the ambiguities created by prior decisions of the court pertaining to liquidated damages provisions. 688 P2d at 383. In its analysis, the court relied on a provision of the Uniform Commercial Code as adopted in Oregon, ORS 72.7180(1)[1] for guidance: "It is true

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This article is not intended to provide legal advice. The author thanks Loren Snow, Schwabe, Williamson & Wyatt, for research assistance. The views expressed are those of the author and are not necessarily those of Schwabe, Williamson & Wyatt or the American College of Real Estate Lawyers. Any errors are those of the author. For a more detailed treatment of the subject of liquidated damages issues in Oregon, the author recommends Chapter 29, Damages, authored by Thomas C. Peachey and Andrew J. Myers (Oregon State Bar Publications, 2016 Revision).

[1] Damages for breach by either party may be liquidated in the agreement but only in an amount which is reasonable in the light of the anticipated or actual harm caused by the breach, the difficulties of proof of loss, and the

that the legislature's choice, by its terms, applies only to contracts for the sale of goods, but we are unable to perceive any good reason for not using that same rule as the initial point of departure for analyzing the validity of provisions for liquidated damages in contracts in general." 688 P2d at 389-390.

The court also cited with approval Restatement (Second) of Contracts, §356(1)[2], and the accompanying commentary. 688 P2d at 390. The court affirmed the decision of the Court of Appeals finding that there was sufficient evidence produced at trial to support a decision of the trial court on the principal criteria identified: the amount stipulated as liquidated damages (i) was not reasonable in light of anticipated or actual harm caused by the breach, and (ii) was void as a penalty inasmuch as the amount stipulated was unreasonably large. 688 P2d at 390. In reaching this decision, the court referred to support of "the findings of the trial judge on both criteria mentioned above." 688 P2d at 390, emphasis added. Notwithstanding the reference to two criteria in the decision, a third element of the test to be satisfied pursuant to this decision would appear to be a finding that the damages to be covered by the stipulated amount were difficult to estimate at contract execution (as contemplated by ORS 72.7180[1]), but the court found that it was unnecessary to analyze the text of the UCC provision to reach its decision: "We are presently of the belief that the same result would obtain if the text of ORS 72.7180(1) were the point of departure, but it is not necessary that we here interpret or construe that text, and we do not do so." 688 P2d at 390.

Selected Issues

1. May the seller choose specific performance instead of liquidated damages (so that liquidated damages are not an exclusive remedy)?

In Oregon, specific performance of a contract is an equitable action available to a party if the principal terms of the contract are clear and complete. Howard v. Thomas, 526 P2d 552, 553 (Or 1974), citing Smith v. Vehrs, 242 P2d 586 (Or 1952). The Howard court noted a preference to judicially provide less important details of contracts when a real estate conveyance is involved:

> With respect to specific performance of contracts for the sale of land we prefer a less restrictive rule than that announced in Smith v. Vehrs. "The law does not favor, but leans against, the destruction of contracts because of uncertainty; and it will, if feasible, so construe agreements as to carry into effect the reasonable intentions of the parties if that can be ascertained." 526 P2d at 554, quoting 11 Williston on Contracts (3d ed) 813, §1424.

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inconvenience or nonfeasibility of otherwise obtaining an adequate remedy. A term fixing unreasonably large liquidated damages is void as a penalty. ORS 72.7180(1).

[2] Damages for breach by either party may be liquidated in the agreement but only at an amount that is reasonable in 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. Restatement (Second) of Contracts, §356(1)

> "If there is sufficient intent expressed to make a legally valid contract, a court of equity can make certain by its decrees, within reasonable limits, subordinate details of performance which the contract itself does not state." 526 P2d at 555, quoting 11 Williston on Contracts (3d ed) 814, §1424.

Another consideration undertaken by a court when determining whether specific performance will be granted is whether the claimant has an adequate remedy at law: "If adequate relief may be obtained in law, then equitable jurisdiction will not be invoked." Thompson v. Coughlin, 997 P2d 191, 195 (Or 2000). An Oregon appellate court, in conjunction with its ruling that the forfeiture and retention of earnest money pursuant to the express terms of the contract precluded the buyer's action for return of the earnest money deposit and an action for specific performance as well as the seller's counterclaim for damages, noted that the presence of a liquidated damages clause does not necessarily eliminate the option of pursuing specific performance if permitted by a contract:

> The presence of a liquidated damage or forfeiture clause will not per se preclude specific performance. Martin v. Dillon, 642 P2d 1209, 1211 (Or App 1982), citing Slattery v. Gross, 190 P2d 577 (Or 1920); Uribe v. Olson, 601 P2d 818 (Or App 1979); 5A Corbin, Contracts, §1213 (1964).
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> However, the seller of land will be denied the remedy of specific performance if the language of the contract discloses that the parties intended to limit the seller to recovery of liquidated damages upon the purchaser's default. 642 P2d at 1212, citing Uribe; and Potter Realty Co. v. Derby, 147 P 548 (Or 1915).

A seller conceivably could retain a right to seek specific performance of a real estate contract on breach by the buyer, but an obstacle to succeeding with that claim is the general requirement that the claimant does not have an adequate remedy at law. As a practical matter, it is a customary practice in Oregon to limit the remedies of a seller under a real estate contract to termination of the contract and retention of the earnest money upon breach by the buyer and any prudent buyer would not grant a seller a right to pursue specific performance. Despite the complications inherent in issuing a decree of specific performance in favor of a seller, Oregon courts have granted sellers the right to specifically enforce real estate contracts. See, e.g., Western Hills, Oregon, Ltd. v. Pfau, 508 P2d 201 (Or 1973).

2. May the seller choose actual damages instead of liquidated damages (so that liquidated damages are not an exclusive *damage* remedy)?

Presumably that option could be reserved in a real estate contract, but such a provision would undermine one of the elements required to enforce a liquidated damages clause – the inability of the parties to accurately estimate damages to be suffered by a seller. It may behoove a prudent seller to retain the option to recover actual damages, if the liquidated damages provision is not enforced, particularly when the current practice is to provide that the seller's exclusive remedy is to retain the earnest money. The Illingworth court concluded that the liquidated damages clause in question in that case was unreasonably large, and reduced the

recovery of the seller to the amount it perceived to be the actual damages. Presumably, other Oregon courts would follow that course of action if a contract provides that the retention of the liquidated amount is the exclusive remedy of the seller, because to do otherwise would leave the seller without a remedy. Also note that a prudent buyer would not be willing to expose itself to an unlimited damages claim by a seller.

3. If the seller may choose liquidated damages or actual damages, may it have both?

There does not appear to be an Oregon decision relevant to this question, but such a recovery would be highly unlikely because it would be contrary to election of remedies doctrines and one of the requirements to be met to enforce liquidated damages: actual damages which may be suffered by the seller are not ascertainable at the time of contract execution.

4. If the seller may choose liquidated damages or actual damages, but not both, when must it decide?

In Sheppard v. Blitz, 163 P2d 519 (Or 1945), the plaintiff's action to rescind a contract was granted and then overturned on appeal, at which time the plaintiff chose to recover damages for breach of the contract. In the course of concluding that the action of the plaintiff to rescind the contract was not an irrevocable election, the Oregon Supreme Court cited with approval Restatement of the Law of Restitution, §68:

> A person who avoids a transaction is not entitled to subsequently affirm the transaction, unless the avoidance was induced by the fraud, material representation or duress of the transferee. A person does not avoid a transaction until: (a) he has regained all or a substantial part of what he gave and to which he would be entitled only upon avoidance, or (b) he has obtained a final judgment or decree based upon the avoidance, or (c) the other party has changed his position in reliance upon a statement of disaffirmance or has manifested his consent thereto. 163 P2d at 509, quoting Restatement of the Law of Restitution, §68, 275.

The upshot of this decision and similar cases is that once the decision becomes irrevocable by being reduced to judgment, by making the claimant whole, or by causing the other party to change its position in reliance upon the action, then the election of the remedy has been made and alternative remedies have been forsaken.

5. Is there an applicable statute addressing liquidated damages clauses?

There is no statute in Oregon governing these clauses, but as noted above the Illingworth court included a provision of the Uniform Commercial Code as adopted in Oregon for guidance in its decision.

6. What is the test for a valid liquidated damages clause?

The test, as outlined in Illingworth, is three-pronged: (i) the damages to be covered by the stipulated amount must be difficult to estimate at contract execution, (ii) the stipulated amount must be reasonable in light of anticipated or actual harm caused by the breach, and (iii) the stipulated amount must not be unreasonably large.

7. Who has the burden of proof?

Although a clear holding on this issue has not been found, Oregon courts in dictum have suggested the burden should be placed on the opponent challenging the enforceability of the liquidated damages agreement. See, e.g., Illingworth; Chaffin v. Ramsey, 555 P2d 459 (Or 1976); Layton Mfg. Co. v. Dulien Steel, Inc., 560 P2d 1058 (Or 1977); and Dean Vincent, Inc. v. McDonough, 574 P2d 1096 (Or 1978).

8. As of when is "reasonableness" tested?

In Wright v. Schutt Construction Co., 500 P2d 1045 (Or 1972), overruled in part by DiTommaso Realty, Inc. v. Moak Motorcycles, Inc., 785 P2d 343 (Or 1990), the court noted:

> There is general agreement, however, with the proposition that a contract provision for liquidated damages will not be declared to be a penalty because the stipulated amount to be paid as damages is more than the amount of the actual damages unless the stipulated amount is "grossly disproportionate," or has no "reasonable relation" to the probable loss, as anticipated at the time of the contract. 500 P2d at 1047, citing McCormick, Damages, 607, §149 (1935).

Affirming the trial court decision that payment of a $200,000 commission in connection with the wrongful termination of a commission agreement was not a reasonable estimation of damages to be suffered, the court did not reach the issue of whether the proponent was required to deduce evidence of the probability that the commission would have been earned had the commission agreement not been terminated, concluding that the clause was unenforceable because no effort was made to reasonably estimate the damages to be suffered by termination of the contract. 500 P2d at 1049-1050.

The third prong of the Illingworth test – a requirement that the damages to be covered by the stipulated amount must not be unreasonably large – appears to open the door to an analysis of the stipulated amount in hindsight if the proponent fails to produce evidence that the estimated damages was reasonably calculated and the opponent produces evidence that the actual damages were significantly less than the amount stipulated.

9. What percentage of the purchase price is likely acceptable as liquidated damages?

The amount of earnest money put at risk is typically a negotiated term in a commercial real estate transaction and there are no hard and fast rules with respect to the amounts stipulated. Parties rarely select a percentage of the purchase price as a stipulated damages amount, instead choosing fixed amounts which would serve to make the seller whole if the transaction fails considering deal costs and lost opportunities and also designed to create some certainty that the purchaser will proceed to closing after contingencies are satisfied. The amounts stipulated often will escalate over time as milestones are achieved to further enhance the expectation that the purchaser will proceed to closing. If a seller desires to require payment of an extraordinary amount of earnest money to serve its business interests, it would behoove the seller's counsel to consider converting the contract to an option and characterizing the earnest money as an option payment inasmuch as an option payment is viewed as the price paid for the privilege of having

the option to purchase the property and presumably would not be subject to a liquidated damages analysis.

10. Are actual damages relevant for liquidated damages and, in particular, will liquidated damages be allowed when there are no actual damages?

The Illingworth case illustrates the difficulties a seller will encounter in enforcing a liquidated damages clause when it is clear that no thought was given to the calculation of the amount (10% of the price was randomly chosen as the figure in Illingworth), the seller fails to produce any evidence that the figure chosen was a fair estimate of actual damages which might be suffered by reason of the purchaser's breach, and the opponent of the clause produces evidence that the actual damages were nominal. See also Stephenson v. Great Frame Up System, 184 F Supp 2d 1048, 1057 (D Or 2002) (a $1,000 per week liquidated damage clause for violation of a non-compete agreement was deemed a penalty because the amount payable "would be a sheer windfall, not compensation for damages suffered. . . .") The courts have allowed evidence of actual damages suffered to determine whether the forecast of liquidated damages was reasonable, but have concluded that the claimant is precluded from recovering actual damages when the validity of the liquidated damages clause is upheld. See, e.g., Heinkel v. City of Corvallis, 510 P2d 579, 582 (Or App 1973).

11. Is mitigation relevant for liquidated damages?

In LTR Rental Co. v. Simmons, 595 P2d 1283 (Or App 1979), the court considered a claim of the opponent of the liquidated damages clause to the effect that the proponent of the clause could have reduced actual damages by mitigation, but found no evidence to support the arguments made and noted the following, citing Heinkel v. City of Corvallis, 510 P2d 579 (Or App 1973):

> Although indirectly relevant for determining the validity of a liquidated damage provision [i.e., to ascertain whether the forecast amount of damages was reasonable], plaintiff's actual damages and its ability to mitigate them are not relevant once that validity [of the liquidated damages clause] is established. 595 P2d at 582.

12. Is a "Shotgun" liquidated damages clause enforceable?

Presuming that a "shotgun" liquidated damage clause is one that requires payment of the stipulated sum without regard to the materiality of the breach, there appears to be no case on point in Oregon real estate transactions. That is likely a result of the typical formulation of the clause in commercial real estate contracts – the forfeiture of the earnest money is triggered by a material breach: the failure of the purchaser to close.

13. Does a liquidated damages clause preclude recovery of attorney fees by the seller?

In Domingo v. Anderson, 938 P2d 206 (Or 1997), the Supreme Court noted the principal requirement for recovery of attorney fees, citing Mittiza v. Foster, 803 P2d 723 (Or 1990):

> In Oregon, the general rule is that the prevailing party in a legal proceeding is not entitled to an award of attorney fees unless the award is authorized by statute or a specific contractual provision. 938 P2d at 207.

If the real estate contract is properly drawn to include a prevailing party attorney fee clause, then attorney fees incurred in the context of litigation will be recoverable in addition to permissible liquidated damages. Inasmuch as most commercial real estate contracts provide that the seller's exclusive remedy is retention of the earnest money and termination of the contract, it would behoove seller's counsel to include the right of the seller to pursue any actions required to recover the earnest money.

Conclusion:

Despite the efforts of the Illingworth court to clarify the line of Oregon decisions relevant to liquidated damages and pronounce a test to determine enforceability of such clauses, much remains unclear. A less restrictive rule in real estate transactions makes sense. Cases involving failed real estate transactions do not present the same concerns raised in the employment and brokerage agreement arenas where punitive provisions and adhesive contracts come into play and one party may enjoy more leverage than the other. Except for occasional references to the values of judicial economy and freedom of contract, most decisions do not recognize the principal value of liquidated damages clauses to both parties to a deal – limited exposure for a buyer and avoidance of litigation by both parties if a transaction fails to close. If the courts undermine the efficacy of these clauses, sellers will begin to pursue an array of other remedies and that will impede commerce and increase transaction costs. Perhaps it is time for more states to join the State of Washington and adopt legislation which creates a safe harbor for these clauses in real estate transactions.