

## Liquidated Damages in Washington State

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Washington State case law directly addresses the nature and role of liquidated damages in commercial real estate purchase and sale agreements. Washington courts have historically remained open to the remedy of either liquidated damages or specific performance in this context, as well as the alternative of recovering actual damages, if the parties have contracted to preserve such a remedy. However, the Washington State legislature's passage of a "Safe Harbor" statute in the early 1990's implemented a manner by which parties can assure liquidated damages will serve as the exclusive remedy in case of breach. Now, contracting parties may choose to conform to the Safe Harbor's limitations (earnest money amount totaling less than 5% of purchase price), but foreclose alternative remedies otherwise contractually available, including actual damages.

### **1. MAY THE SELLER CHOOSE SPECIFIC PERFORMANCE INSTEAD OF LIQUIDATED DAMAGES (SO THAT LIQUIDATED DAMAGES ARE NOT AN EXCLUSIVE REMEDY)?**

Washington State case law provides that specific performance is available absent language specifying liquidated damages as the sole remedy.<sup>1</sup> In Washington State, courts acknowledge the "long-held rule" that "a liquidated damages clause in a real estate purchase and sale contract does not foreclose the remedy of specific performance absent language in the contract specifying liquidated damages to be the sole and exclusive remedy."<sup>2</sup> However, while case law establishes liquidated damages are not an exclusive remedy, Washington State's "Safe Harbor" statute supplies a method by which forfeiture of the earnest money upon a buyer default, as liquidated damages, *may* be made an exclusive remedy, provided that the earnest money is 5% or less of the purchase price.<sup>3</sup>

### **2. MAY THE SELLER CHOOSE ACTUAL DAMAGES INSTEAD OF LIQUIDATED DAMAGES (SO THAT LIQUIDATED DAMAGES ARE NOT AN EXCLUSIVE DAMAGE REMEDY)?**

While Washington courts will adhere to a clause obligating sellers to the exclusive remedy of liquidated damages if the Safe Harbor statute is utilized<sup>4</sup>, a liquidated damages clause does not

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<sup>1</sup> *Paradise Orchards Gen. P'ship v. Fearing*, 122 Wn. App. 507, 94 P.3d 372 (2004); *see also Save-Way Drug v. Standard Investment*, 5 Wn. App. 726, 728, 490 P.2d 1342 (1971) ("The fact that a contract contains a provision for the payment of a penalty or liquidated damages for breach...is not a bar to the specific enforcement of the promise").

<sup>2</sup> *Paradise Orchards Gen. P'ship v. Fearing*, 122 Wn. App. 507, 518, 94 P.3d 372 (2004)(citing *Asia Inv. Co. v. Levin*, 118 Wash. 620, 624-627, 204 P. 808 (1922)).

<sup>3</sup> RCW 64.04.005 (see Appendix A for complete text of statute).

<sup>4</sup> *Id.*

necessarily preclude a party from suing for actual damages, if the contract so provides.<sup>5</sup> However, case law implies a liquidated damages clause, alone, with no express reservation of the right to also seek actual damages would preclude such a right.<sup>6</sup>

**3. IF THE SELLER MAY CHOOSE LIQUIDATED DAMAGES OR ACTUAL DAMAGES, MAY IT HAVE BOTH?**

Washington courts will uphold liquidated damages clauses so long as the sums involved do not constitute a penalty.<sup>7</sup> The simultaneous pursuit of both liquidated damages and actual damages generally constitutes a sum amounting to a penalty, and the remedies should be sought in the alternative.

**4. IF THE SELLER MAY CHOOSE LIQUIDATED DAMAGES OR ACTUAL DAMAGES, BUT NOT BOTH, WHEN MUST IT DECIDE?**

As a general matter, parties must elect at the time of contracting what remedies will be available. If parties wish to have forfeiture of the earnest money as liquidated damages serve as the exclusive remedy, the agreement should reflect that, in accordance with the Safe Harbor statute (provided that the earnest money deposit is 5% or less of the purchase price.) If parties wish to retain other remedies (i.e. actual damages or specific performance), the right to pursue those remedies in the alternative should be expressly reserved in the contract. But, the Safe Harbor statute will then not be available. Assuming that the right to pursue liquidated damages or actual damages was reserved in the agreement, then Washington State case law suggests the parties may plead in the alternative.<sup>8</sup>

**5. IS THERE AN APPLICABLE STATUTE ADDRESSING LIQUIDATED DAMAGES CLAUSES?**

Yes, Washington State has a “Safe Harbor” statute, addressing liquidated damages in the context of real property purchase and sale agreements.<sup>9</sup> Under RCW 64.04.005, a liquidated damages agreement stating that retention of the earnest money, or liquidated damages, is the exclusive remedy for a buyer default in closing the purchase will be enforceable, regardless of actual damages or the reasonableness of such amount, *if the earnest money deposit is five percent or less of the sale price.*<sup>10</sup> The application of the statute’s safe harbor is contingent on the

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<sup>5</sup> See *Noble v. Ogborn*, 43 Wn. App. 387, 391, 717 P.2d 285 (1986) (“A liquidated damages clause does not preclude a party from suing for actual damages if that right is preserved in the contract between the parties.”); see also *Reiter v. Bailey*, 180 Wash. 230, 39 P.2d 370 (1934).

<sup>6</sup> See *Mahoney v. Tingley*, 85 Wn.2d 95, 529 P.2d 1068 (1975).

<sup>7</sup> *Wallace Real Estate Inv., Inc. v. Groves*, 124 Wn.2d 881,886, 881 P.2d 1010 (1994).

<sup>8</sup> See *Noble v. Ogborn*, 43 Wn. App. 387, 717 P.2d 285 (1986) (Court rejected breaching party’s argument that non-breaching party (Noble) was precluded from seeking other relief when Noble sued for liquidated damages; Noble pleaded in his complaint in the alternative for specific performance, liquidated damages, or actual damages, thus no election was made, which is permissible under CR8(a)).

<sup>9</sup> RCW 64.04.005.

<sup>10</sup> *Id.* (emphasis added).

exclusivity of earnest money forfeiture as liquidated damages as the seller's sole remedy. Furthermore, as confirmed in case law, if the statute does not apply (in cases where the amount of the deposit exceeds 5%) the safe harbor is not available.<sup>11</sup> The fact the safe harbor is not available does not render the liquidated damage provision unenforceable; it merely removes the contractual provision from the application of the statute.

## **6. WHAT IS THE TEST FOR A VALID LIQUIDATED DAMAGES CLAUSE?**

The Washington State Supreme Court discussed the test for valid liquidated damages clauses in companion cases: *Wallace Real Estate Inv., Inc. v. Groves*<sup>12</sup> and *Watson v. Ingram*.<sup>13</sup> The court rejected prior case law utilizing a 3-prong test, opting instead for a "single-factor" approach, focusing on the reasonableness of the estimate of loss.<sup>14</sup> In doing so, the Court discussed that proof of actual damages is not required, but courts may consider them to evaluate the reasonableness of the estimate. A provision bearing no reasonable relation to actual damages will be construed as a penalty.<sup>15</sup>

## **7. WHO HAS THE BURDEN OF PROOF?**

While not discussed thoroughly, Washington case law denotes the burden is on the non-breaching party to establish the reasonableness of a liquidated damages provision.<sup>16</sup>

## **8. AS OF WHEN IS "REASONABLENESS" TESTED?**

The reasonableness of liquidated damages is measured at the time of contract formation.<sup>17</sup>

## **9. WHAT PERCENTAGE OF THE PURCHASE PRICE IS LIKELY ACCEPTABLE AS LIQUIDATED DAMAGES?**

Under Washington's Safe Harbor statute, an agreement for an earnest money deposit that is 5% or less of the purchase price, and which expressly states forfeiture of the earnest money is the exclusive remedy, will be upheld, *regardless* of whether the earnest money is a reasonable estimate of damages or the seller incurred any damages. Most buyers and sellers in Washington State utilize this Safe Harbor statute.

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<sup>11</sup> *Paradise Orchards Gen. P'ship v. Fearing*, 122 Wn. App. 507, 518-519, 94 P.3d 372 (2004).

<sup>12</sup> 124 Wn.2d 881, 881 P.2d 1010 (1994).

<sup>13</sup> 124 Wn.2d 845, 881 P.2d 247 (1994).

<sup>14</sup> *Wallace Real Estate Inv., Inc. v. Groves*, 124 Wn.2d 881, 893, 881 P.2d 1010 (1994)(citing *Watson v. Ingram*, 124 Wn.2d 845, 881 P.2d 247 (1994)).

<sup>15</sup> *Id.*

<sup>16</sup> *Watson*, 124 Wn.2d at 851.

<sup>17</sup> *Watson v. Ingram*, 124 Wn.2d 854, 881 P.2d at 247 (1994); *see also Wallace Real Estate Inv., Inc. v. Groves*, 124 Wn.2d 881, 890, 881 P.2d 1010 (1994) ("Our prior case law...supports the position...that reasonableness at the time of contracting is the key in evaluating liquidated damages clauses").

As evidence of the outer limits, a liquidated damages provision in a commercial real estate contract was upheld as not unreasonable where the total sum forfeited by nonperformance by purchaser's assignee amounted to 17% of a contract price of \$1,520,000.<sup>18</sup> We consider this result unusual and resulting from the specific facts of the case.

**10. ARE ACTUAL DAMAGES RELEVANT FOR LIQUIDATED DAMAGES AND, IN PARTICULAR, WILL LIQUIDATED DAMAGES BE ALLOWED WHEN THERE ARE NO ACTUAL DAMAGES?**

Washington case law generally does not impose the requirement of actual damages as part of its test for determining the validity of a liquidated damages clause.<sup>19</sup> However, actual damages may be pertinent for purposes of determining whether a liquidated damages amount is reasonable, in unusual cases.<sup>20</sup> Additionally, actual damages are irrelevant if one falls under the Safe Harbor statute.

**11. IS MITIGATION RELEVANT FOR LIQUIDATED DAMAGES?**

Washington case law does not discuss the role of mitigation and liquidated damages clauses in the context of commercial real estate transactions. Mitigation is not relevant under the Safe Harbor statute.

**12. IS A "SHOTGUN" LIQUIDATED DAMAGES CLAUSE ENFORCEABLE?**

Washington case law does not utilize the phrase "shotgun" clause with respect to liquidated damages provisions. However, the Washington Court of Appeals held a breach must be material, in denying a party liquidated damages when the breach was immaterial.<sup>21</sup>

**13. DOES A LIQUIDATED DAMAGES CLAUSE PRECLUDE RECOVERY OF ATTORNEYS' FEES BY THE SELLER?**

It would appear no; Washington courts will look to the language of the purchase and sale contract to ascertain whether the parties contracted for recovery of attorneys' fees as part of the remedy available to the prevailing party.<sup>22</sup>

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<sup>18</sup> *Wallace Real Estate Inv.*, 124 Wn.2d 881 (1994).

<sup>19</sup> *Wallace Real Estate Inv., Inc. v. Groves*, 124 Wn.2d 881, 892, 881, P.2d 1010 (1994) ("We thus conclude that proof of actual damages is not required as a prerequisite to upholding a liquidated damages clause...").

<sup>20</sup> *Id.* at 894 ("[W]hile proof of actual damages is no longer a requirement... actual damages may be considered where they are so disproportionate to the estimate that to enforce the estimate would be unconscionable").

<sup>21</sup> *McEachren v. Sherwood & Roberts, Inc.*, 36 Wn. App. 576, 675 P.2d 1266 (1984) (Breaching party did not sign rental agreement).

<sup>22</sup> *Id.*; see also *Woodruff v. McClellan*, 95 Wn.2d 394, 622 P.2d 1268 (1980) (Where both sides sought attorneys' fees pursuant to an earnest money agreement—stating that in event either party institutes suit to enforce rights under agreement, the successful party shall be entitled to reasonable attorneys' fees—the prevailing party was entitled to the same).

## **Conclusion**

Washington State recognizes the freedom parties to commercial real estate purchase and sale agreements to contract for certain remedies, including but not limited to, liquidated damages. Increasingly, parties elect to enjoy the “safe harbor” provided by RCW 64.04.005, but this statute does not foreclose parties’ abilities to retain alternate remedies should they choose.

## APPENDIX A

### RCW 64.04.005

#### **Liquidated damages—Earnest money deposit—Exclusive remedy—Definition.**

(1) A provision in a written agreement for the purchase and sale of real estate which provides for liquidated damages or the forfeiture of an earnest money deposit to the seller as the seller's sole and exclusive remedy if a party fails, without legal excuse, to complete the purchase, is valid and enforceable, regardless of whether the other party incurs any actual damages. However, the amount of liquidated damages or amount of earnest money to be forfeited under this subsection may not exceed five percent of the purchase price.

(2) For purposes of this section:

(a) "Earnest money deposit" means any deposit, deposits, payment, or payments of a part of the purchase price for the property, made in the form of cash, check, promissory note, or other things of value for the purpose of binding the purchaser to the agreement and identified in the agreement as an earnest money deposit, and does not include other deposits or payments made by the purchaser; and

(b) "Liquidated damages" means an amount agreed by the parties as the amount of damages to be recovered for a breach of the agreement by the other and identified in the agreement as liquidated damages, and does not include other deposits or payments made by the purchaser.

(3) This section does not prohibit, or supersede the common law with respect to, liquidated damages or earnest money forfeiture provisions in excess of five percent of the purchase price. A liquidated damages or earnest money forfeiture provision not meeting the requirements of subsection (1) of this section shall be interpreted and enforced without regard to this statute.