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Commentary: Don't Overlook a Contract's Liquidated Damages Provision

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Kevin Phelan set out to buy the opulent 72,000 sq. ft. former headquarters of Adelphia Communications in Coudersport, Pa. in 2008. That's when his trouble began. He was double-crossed by his real estate attorney and the money deposited in the attorney's trust account for the purchase was soon packed aboard a plane headed to South America.

Phelan probably never imagined that, having been the victim of his attorney's crime, he would still lose his \$1 million deposit when he defaulted on the closing of the property. The liquidated damages clause in his contract, an often-overlooked contract provision in commercial real estate transactions, made a million-dollar difference.

Phelan paid a \$1 million nonrefundable deposit on the \$3.4 million deal, and gave his attorney nearly \$2 million to forward to the escrow agent. But a separate client of the attorney reportedly persuaded the lawyer to let him use \$1.9 million of

Phelan's money for a suspect bank loan transaction. The man then attempted to flee with the money to Venezuela on a private jet with his unsuspecting wife, children and dog. He was caught on the tarmac in Miami with \$1.3 million in cash hidden in his luggage.

Phelan sued Adelphia to get his deposit back. But recently, the U.S. District Court for the Middle District of Pennsylvania upheld Adelphia's right to keep the \$1 million as liquidated damages.

Liquidated damages come into play when a buyer or seller defaults on a sale agreement. Rather than litigating the amount of damages caused by the default, the parties agree in advance to specify how much a defaulting party will pay, regardless of what damages were actually suffered. Property sellers prefer liquidated damages clauses because if the buyer defaults, they don't have to chase the buyer to recover damages. And buyers can limit downside risk if they default for any reason. The purpose is to protect the parties from the uncertainty of damages that result in a default. At times, a damages provision can produce a windfall for the non-defaulting party.

TERMS MUST BE CLEAR

Because liquidated damages provisions can produce harsh results, the terms must be clear and meet certain requirements to be enforced. Real estate investors and developers need to be familiar with these requirements.

If the amount of damages is too high, it will be regarded as a “penalty” that is not enforceable. When the contract is executed, actual damages upon a default must first be uncertain or difficult to compute, and second, the agreed-upon sum must be a reasonable approximation of the potential loss. After Phelan

defaulted and forfeited his \$1 million deposit, Adelphia found a new buyer who closed the deal at a slightly higher price. Then Phelan sued to get his \$1 million deposit back, claiming the provision was invalid as an unenforceable penalty.

The court refused to consider the reasons for Phelan's default, even though the attorney who defrauded Phelan was eventually disbarred and jailed. The court also rejected Phelan's argument that Adelphia had not actually suffered damages from his default because they sold the property at a higher price.

But the legal test is not what the non-defaulting party's actual damages are, but rather what the damages potentially were when the agreement was made. Adelphia presented evidence that when Phelan signed the contract, there were some \$600,000 in annual carrying costs for the property, remarketing costs, and uncertainty about how long it would take to resell the property and at what price. The court found the \$1 million amount met the two basic requirements for a valid liquidated damages clause.

Using a standard percentage (like 10%) for liquidated damages in a real estate transaction may undermine the enforceability of that provision. The liquidated damages amount should be chosen based on circumstances of the transaction. The seller should create an internal record at or before the time the agreement is signed, documenting both the uncertainty and amount of potential damages that might result from a default by the buyer. The buyer should record damages it might suffer if the seller defaults. Failure to do so may void the liquidated damages clause, forcing the non-defaulting party to chase the other side to recover actual damages. And failure to follow these guidelines could make a million-dollar difference.

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