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Indiana Court of Appeals Revisits Enforceability of Liquidated Damages

This past week the Indiana Court of Appeals had an opportunity to revisit and to further develop Indiana breach of contract law. Specifically, the court weighed in on the issue of whether the requirement of the payment of \$100,000 in earnest money for the \$4 million sale of real property constituted an enforceable liquidated damages provision. The case, *Dean V. Kruse Foundation, Inc. v. Gates*, not only allowed the Court of Appeals to revisit the topic but also has allowed the attorneys here at Pavlack Law to further discuss how liquidated damages factors into the process of calculating contract damages.

Recall that in a previous post on Contract Damages we discussed the various ways in which a court could calculate damages for breach of contract. One of those ways is through liquidated damages. Something that we touched on in our prior post but did not go into great detail discussing is why a court may or may not enforce a liquidated damages provision. That was precisely the issue in the case before the Court of Appeals. In this case, *Kruse II* – referred to as II because this is actually the second appeal of the same case decided by the Court of Appeals – the court was asked to weigh in on whether a seller of property could seek traditional contract damages for the breach of the sales agreement or was entitled only to the

liquidated damages of \$100,000. Now, while \$100,000 certainly seems like a lot of money, the seller was seeking \$2,468,794 in damages. So, it is pretty easy to see why this was a big enough case to be appealed twice.

The basic facts of the case are that the plaintiff was a charity to whom a piece of property was donated. After a long period of not being able to afford to keep the property the charity decided to hold an auction to sell it. It procured a buyer who agreed to pay \$4 million plus an additional \$200,000 fee. The two parties entered into an agreement and the buyer placed \$100,000 down as earnest money. After that, the buyer backed out of the deal. Ultimately, the best price the seller could find from another buyer was \$2.35 million – a difference of \$1.85 million. As a result the seller brought a claim against the original buyer who breached the contract for its damages.

Now if you recall our discussion from our previous post on Contract Damages, you will remember that the standard approach to calculating damages for breach of contract is expectation damages. In expectation damages you look at what the non-breaching party expected to get out of the contract and then the position that it was left in after the other party breached the contract. In this case, the seller was expecting \$4.2 million for the property and upon the breach ended up settling for \$2.35 million. That difference is \$1.85 million. Now you might be wondering how then the seller was seeking almost \$2.5 million in damages. Well the answer is that the seller was seeking pre-judgment interest, which placed the damages even higher. The trial court found that the earnest money constituted liquidated damages and as such it was the only damages to which all that the seller was entitled.

This is an interesting case in many ways when it comes to the concept of liquidated damages. The vast majority of cases in which liquidated damages is an issue it is an issue raised by a defendant who is contending that the liquidated damages provision is an unreasonably high cost in excess of expectation damages and as such it is acting as a penalty to breaching the contract. One very important point to understanding liquidated damages is that the law recognizes the concept of efficient breach. What this means is that the law generally allows people to breach their contract at any point with no additional liability. However, that does not mean that the breaching party does not owe damages on the contract. What it does mean is that the party cannot owe more than the expectation damages on the contract. Put simply, nothing in a contract can be enforced that has the sole purpose of stopping a party from breaching or punishes a party for doing so.

The issue in this case was whether that \$100,000 earnest money constituted a liquidated damages provision. The Court of Appeals held that it did not. So, after

all this time talking about liquidated damages you are probably curious what exactly liquidated damages are. “A liquidated damages clause provides for the forfeiture of a stated sum of money upon a breach of contract without proof of damages.” Basically, it is a clause that specifies how much one party to a contract owes the other party if the contract is breached. “Liquidated damages clauses are generally enforceable where the nature of the agreement is such that damages for breach would be uncertain, difficult, or impossible to ascertain.” The primary purpose for enforcing liquidated damages clauses is that it saves both parties time, money, and needless litigation if the amount is agreed upon.

However, remember, breach cannot be penalized. So, for a liquidated damages clause to be enforceable it needs to have some rational relationship to what the actual expectation damages are for the breach. In this case it was not ultimately that the \$100,000 was grossly disproportionate to the almost \$2.5 million sought that won the day for the plaintiffs. What carried the day for the seller was that (1) they used a form contract going into the auction; (2) that the earnest money amount was used to pre-screen bidders; and (3) that the value of the property was not uncertain. By using the form contract that meant that regardless of what the final purchase price the earnest money amount was still \$100,000. Since the final bid was \$4 million this amount seems unreasonably low given the sale for \$2.35 million. However, what if the final bid was \$2.351 million? In that case with the later sale of \$2.35 million the difference would have only been \$10,000. Yet, the damages provision would have entitled the seller to \$100,000.

Ultimately, the seller succeeded in establishing that the \$100,000 earnest money was not a liquidated damages clause that could be enforced. As such, they will be able to seek their full expectation damages for the buyer’s breach of the contract

When it comes to contract damages and specifically liquidated damages the law can be extremely complex. Thus, it is always wise when faced with such an issue to seek counsel from an attorney that knows Indiana law, is experienced, and can zealously advocate to protect your rights.

Join us again next week.

Sources

- *Dean V. Kruse Found., Inc. v. Gates*, 973 N.E.2d 583 (Ind. Ct. App. 2012), *trans. denied*.

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