

OPTIONAL LIQUIDATED DAMAGES IN ARKANSAS COMMERCIAL REAL ESTATE PURCHASE AND SALE AGREEMENTS



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Parties to commercial real estate purchase and sale agreements commonly include liquidated damages provisions whereby the parties agree to the amount of damages a non-breaching party will receive in the event of a breach. The purpose of this article is to inform sellers about Arkansas law on liquidated damages provisions in commercial real estate purchase and sale agreements.

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

In Arkansas, if a commercial real estate purchase and sale agreement states liquidated damages shall be the exclusive remedy for breach of the agreement, liquidated damages are the exclusive remedy. If, however, the agreement does not state liquidated damages are the exclusive remedy, the seller will have the option of accepting the liquidated damages or electing specific performance. See *Logue v. Seven-Hot Springs Corp.*,

926 F.2d 722, 724-25 (8th Cir. 1991) (discussing Arkansas law and finding “specific performance will be allowed on a contract for the sale of land even though there is a liquidated damages clause unless it is clear that the liquidated damages clause was to be the exclusive remedy.”). It should be noted that under Arkansas law, both buyers and sellers may seek specific performance of real estate contracts. *Elder Const. Co. v. Ivey Lane, LLC*, 2010 Ark. App. 10, at 7, 370 S.W.3d 861, 865; *Bharodia v. Pledger*, 340 Ark. 547, 553, 11 S.W.3d 540, 544 (2000). However, Arkansas courts have found that in order to grant specific performance, there must be mutuality of remedy as of the time performance is sought. *McIlwain v. Bank of Harrisburg*, 18 Ark. App. 213, 221, 713 S.W.2d 469, 473-47 (1986) (citations omitted). While Arkansas courts have not recently ruled on the issue of mutuality of remedy and specific performance in the context of real estate purchase and sale agreements, the Arkansas courts have felt bound by

prior decisions on the issue and would most likely still find a seller may seek specific performance so long as there is mutuality of remedy at the time performance is sought. See e.g., *Bharordia*, 340 Ark. at 553, 11 S.W.3d at 544 (“Thus, because the buyers have given us no reason to overturn our previous decisions and because we have allowed both the buyers and the sellers of land to seek specific performance on real estate contracts throughout our case law we do not chose to overrule precedent.”).

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

If a liquidated damages provision states an amount shall become liquidated damages in the event of a breach, liquidated damages are the only damages to which the seller is entitled, but if the provision states an amount may become liquidated damages, the seller may seek either actual damages or liquidated damages. See *Hearrell v. Rogers*, 7 Ark. App. 230, 646 S.W.2d 703 (1983) (court found that liquidated damage clause that stated earnest money shall become liquidated damages was valid, binding, and precluded recovery beyond the liquidated sum); *McMaster v. McIlroy Bank*, 9 Ark. App. 124, 654 S.W.2d 591 (1983) (court found that use of word “may” gives the non-breaching party an option between actual damages and liquidated damages).

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

While some jurisdictions allow a non-breaching party to collect both liquidated and actual damages, in Arkansas, the non-breaching party must choose one or the other, not both, because liquidated damages serve as the contractual substitute for actual damages. *S. Bldg. Servs., Inc. v. City of Ft. Smith*, 2013 Ark. App. 306, at 11, 427 S.W.3d, 769 (citing *Shoptaw v. Puterbaugh*, 263 Ark. 778, 567 S.W. 2d 288 (1978); *Robbins v. Plant*, 174 Ark. 639, 297 S.W. 1027 (1927)).

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

The time at which the seller must decide between collecting liquidated damages or actual damages depends on the type of liquidated damages. When the forfeiture of earnest money may constitute liquidated damages, the seller must decide whether to pursue

liquidated damages at the time of the breach. See *Brackelsberg v. Heflin*, 2011 Ark. App. 678, 386 S.W.3d 636 (non-breaching party kept earnest money and jury determined non-breaching party elected to retain liquidated damages instead of pursue amount of actual damages). Otherwise, the seller will need to elect to pursue liquidated damages or actual damages before filing suit against the buyer.

Is there an applicable statute addressing liquidated damages clauses?

Arkansas does not have a statute that addresses liquidated damages in the context of a commercial real estate purchase and sale agreement, and there is no fixed rule for determining whether a contract properly stipulates for liquidated damages.

What is the test for a valid liquidated damages clause?

Arkansas courts have determined several relevant factors to determine whether a liquidated damages provision is valid. Arkansas courts will uphold liquidated damages provisions where it appears that: (1) the parties contemplated that damages would flow from a failure to perform the contract; (2) such damages would be indeterminate or difficult to ascertain; and (3) the sum bears some reasonable proportion to the damages the parties contemplated might flow from a failure to perform the contract. *Alley v. Rodgers*, 269 Ark. 262, 264, 599 S.W.2d 739, 741 (1980). Thus, under Arkansas law, the liquidated damage amount must bear a reasonable relationship to the damages which the parties believe are likely to result from a breach. If the sum bears no reasonable relationship to the actual damages likely to result from a breach, the amount will be considered a penalty, as opposed to liquidated damages, and will not be enforced. *Muradian v. Haley*, 12 Ark. App. 138, 140, 671 S.W.2d 210, 212 (1984) (court found amount of liquidated damages bore no reasonable relationship to the actual damages likely in the event of a breach and was, therefore, a penalty).

Who has the burden of proof?

The non-breaching party has the burden of proving the liquidated damages amount bears a reasonable relationship to the damages likely to result from a breach. While a non-breaching party is not required to show actual damages, the non-breaching party is required to show the liquidated damage amount is not a penalty. See *McIlvenny v. Horton*, 227 Ark. 826, 831,

302 S.W. 2d 70, 72-73 (1957) (“It was incumbent on the plaintiff to prove, as an essential part of their cause of action, that the contractual provision sued upon represented liquidated damages and not a penalty.”).

As of when is “reasonableness” tested?

The reasonableness of the liquidated damages amount must be determined at the time the contract was entered into. *Robbins v. Plant*, 174 Ark. 639, 297 S.W. 1027, 1030 (1927); See also *Blackwood v. Liebke*, 87 Ark. 545, 113 S.W. 210, 212-13 (1908) (“But the question is not as to the status of the parties when the contract terminated, but as to the status of the parties at the time they made the contract. It may be as the contract works out, that it would be easy to ascertain the damages for the breach of it, or to prove that there were none. But, if the status of the parties at the time of the contract was such that it would be difficult or impossible to have anticipated the damage for a breach of it, and there was a positive element of damage, then under the authorities there is no reason why that may not be anticipated and contracted for in advance.”)

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

Under Arkansas law, there is no mathematical or mechanical formula that can be applied to determine whether a liquidated damage amount is acceptable. *Alley v. Rodgers*, 269 Ark. 262, 264, 599 S.W.2d 739 (1980). For example, in *Alley v. Rodgers*, the court upheld a provision for liquidated damages in the approximate amount of 21 percent of the purchase price, but in *Williams v. Cotter*, 14 Ark. App. 80, 684 S.W.2d 837 (1985), the court held that a liquidated damages provision in the approximate amount of 17 percent of the purchase price constituted a penalty.

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

Although the percentage of the purchase price in *Williams* was less than the percentage in *Alley*, the court found that deposit amount was out of proportion to actual damages incurred and, thus, constituted a penalty. Accordingly, actual damages may be relevant for determining whether the amount of the liquidated damages is reasonable, but it is possible that the stipulated liquidated damage amount will be awarded even if no actual damages are suffered as a consequence of

the breach. See *Robbins v. Plant*, 174 Ark. 639, 297 S.W. 1027, 1030 (1927) (“it is not necessary for the plaintiff to prove any actual loss by reason of the defendants’ breach of contract.”).

Is mitigation relevant for liquidated damages?

In addition to actual damages, mitigation can be relevant for liquidated damages. See *Southern Bldg. Servs., Inc. v. City of Fort Smith*, 2013 Ark. App. 306, at 10-11, 427 S.W.3d 763, 769 (court held that it was not error to deny a claim for liquidated damages when party seeking liquidated damages failed to mitigate its damages).

Is a “Shotgun” liquidated damages clause enforceable?

Arkansas does not have any statutes or case law addressing “shotgun clauses,” which are clauses that fix a single large sum as the liquidated damages for any breach. However, given Arkansas’s requirement that the liquidated damage amount bear a reasonable relationship to the actual damages that may flow from a breach of contract, an Arkansas court would most likely find a shotgun clause unenforceable because the amount of damages would be the same regardless of whether the breach was material or immaterial and would, therefore, not be tailored to bear a reasonable relationship to the damages caused by the breach.

Does a liquidated damages clause preclude recovery of attorneys’ fees by the seller?

Arkansas law does not preclude a non-breaching party from recovering attorneys’ fees when there is a liquidated damages provision. See *Brackelsberg v. Heflin*, 2011 Ark. App. 678, 386 S.W.3d 636 (court found attorneys’ fee provision set forth in real estate contract that included liquidated damages provision was enforceable, but because neither party to the contract was the “prevailing party” in the resulting litigation, as required in the attorneys’ fee provision, neither party was entitled to attorneys’ fees). So long as the commercial real estate purchase and sale agreement includes an attorneys’ fee provision, said provision should be enforceable by the seller even when the seller elects to collect liquidated damages.

CONCLUSION

In Arkansas, a seller’s options with regards to liquidated damages depend on the language used in the commercial real estate purchase and sale agreement. The parties can limit seller’s recovery to the

liquidated damage amount or permit the seller to choose between liquidated damages and actual damages. Despite any agreement the parties may have regarding the amount of liquidated damages, Arkansas courts will not uphold liquidated damage provisions if the amount of damages does not bear a reasonable relationship to the damages likely to flow from a breach. Therefore, when drafting a commercial real estate purchase and sale agreement in Arkansas, sellers should be mindful of the language used in the agreement and the reasonableness of the amount of liquidated damages. 🍀