masuda funai

News & Types: Commercial, Competition & Trade Update

Freedom of Contract Goes Too Far - $4.3 Million Escrow is Not Liquidated Damages, But Unenforceable Penalty

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Practices: Commercial, Competition & Trade, Litigation

One of the principals courts repeatedly cite is that of freedom of contract. For example, in a recent Risk Management Update, we discussed the case of *SAMS Hotel Group, LLC v. Environs, Inc.*, (7th Circuit Court of Appeals, No. 12-2979, May 31, 2013), in which a real estate developer was limited to a $70,000 recovery, in spite of damages exceeding $4 million, due to a contractual damages limitation to which the developer had agreed. The court said freedom of contract includes the freedom to "make a bad bargain." (http://www.masudafunai.com/showarticle.aspx?Show=7656). But a recent Illinois Court of Appeals decision illustrates limits on what courts will enforce in the name of freedom of contract. (*GK Development, Inc. v. Iowa Malls Financing Corporation*, 2013 IL App (1st) 112802, December 19, 2013)

GK Development, Inc. and College Square Mall, LLC (Buyers) purchased four shopping centers in eastern Iowa from Iowa Malls Financing Corporation and College Square Mall Associates, LLC (Sellers) for $117 million in 2004. The major tenant in one of the malls was Hy-Vee Food Stores, which was in the process of expanding its grocery store into space that had been vacated by Wal-Mart. The Buyers highly valued Hy-Vee as a growing tenant and wanted some protection against the risk that Hy-Vee's expansion would not occur. So the Buyers and Sellers negotiated a $4.3 million escrow holdback from the purchase price to be held by Chicago Title and Trust Company. The $4.3 million represented an estimate of the present value of Hy-Vee's expanded lease space. An amendment to the purchase agreement directed Chicago Title to release the holdback only after all the following events occurred:

1. A new Hy-Vee lease was executed by August 31, 2005;
2. The new Hy-Vee leasehold was delivered by the Buyers and accepted by Hy-Vee before October 31, 2005; and
3. Hy-Vee obtained all permits and other governmental approvals necessary to complete the Hy-Vee expansion prior to October 31, 2005.

The dispute arose because all of the events did occur, but not before the dates specified. Each party directed Chicago Title to pay the holdback to itself. Chicago Title understandably declined both directions and litigation ensued.

The trial court found for the Buyers, determining that the dates were intended to be "drop dead" deadlines which, if not met, entitled the Buyers to the entire $4.3 million holdback. But the Illinois Court of Appeals took a different view.

The appeals court analyzed the holdback as a form of liquidated damages. Liquidated damages are often used by parties to a contract to stipulate a certain amount of money that would be used to compensate the non-breaching party. The purpose is to secure performance so that the party that could be subject to the liquidated damages provision knows the consequences of failure or breach. Liquidated damages can be a benefit, as they avoid, or efficiently resolve, disputes as to the amount of loss suffered by the innocent party.

But courts review liquidated damages provisions carefully. The problem is that, while liquidated damages provisions are enforceable, penalties are not. A penalty can be one-sided, a common situation if a party has superior bargaining power to impose a harsh remedy on the other party (although not the situation in this case). The law wants to put parties back in the position they would have been if not for the breach. But the law does not want to give one party an undeserved windfall through a penalty imposed against the other party, disguised as "liquidated damages."

So courts must decide whether a liquidated damages provision is enforceable or is an unenforceable penalty. This is difficult to do when parties are negotiating liquidated damages for situations that have not occurred and whose effects are not known. The court in this case confronted the same issue on appeal – was the holdback a valid and enforceable liquidated damages provision or an unenforceable penalty?

Illinois adopts the rule found in the Restatement (Second) of Contracts:

> "Damages for breach by either party may be liquidated in the agreement but only at an amount that is reasonable in the 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."

According to the appeals court, in doubtful cases, Illinois courts tend to construe a stipulated amount as a penalty.

The appeals court cited factors applied by the Illinois Supreme Court to determine if an amount is an unenforceable penalty or an enforceable liquidated damages provision. The factors are: a) the parties intended to agree in advance to the settlement of damages that might arise from the breach; b) the amount of liquidated damages was reasonable at the time of contracting, bearing some relation to the damages which might be sustained, and c) actual damages would be uncertain in amount and difficult to prove. The provision had to meet all three factors. On this basis, the appeals court held the amount was an unenforceable penalty, failing to meet the first two of the factors.

First, the parties apparently did not agree to the appropriate level of damages arising from the breach. Although the trial court found that the holdback was freely negotiated by parties at "arms length", the appeals court said this was not sufficient. The appeals court required evidence to show that the parties intended to agree in advance that the amount of the holdback represented a reasonable prediction of damages. Simply inserting a holdback provision in the agreement did not show the parties intended that the entire amount was agreed to represent a settlement of damages.

Second, the amount of liquidated damages had no relation to the anticipated damages of a delay in performance. $4.3 million was the present value of the 20 year Hy-Vee lease. As events turned out, the space was delivered to and accepted by Hy-Vee, and all permits obtained, at the end of January, 2006, three months after the deadlines in the agreement. Clearly, the loss to the Buyer, while not insignificant, was nowhere near $4.3 million. Rather, the $4.3 million represented a windfall for the Buyer. Citing an earlier case, the appeals court noted, "The common element to most liquidated damages clauses that get struck down as penalty clauses is that they specify the same damages regardless of the severity of the breach."

It is unusual for a court to rescue a sophisticated commercial entity from its own mistakes. Certainly the Sellers knew the severity of the consequences of even a slight delay in the deadlines set forth in the holdback provision, even if the actual damages were far less. While liquidated damages provisions can be useful in contract negotiations, they must be negotiated carefully. A party in the position of the Sellers in this case may not always be able to count on an appeals court for assistance. In this case, the Sellers should be grateful to the Illinois Court of Appeals, which rescued the Sellers by denying the Sellers the freedom "to make a bad bargain."