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Abstract: Most courts judge the enforceability of liquidated damages clauses as of the time of contract formation. In Lind Building Corp. v. Pacific Bellevue Developments, the court created a "no actual injury" defense to enforcement of liquidated damages clauses by assessing validity as of the time of trial. This Note concludes that a "no actual injury" defense to liquidated damages recovery negates the benefits of agreed remedies, fails to provide a principled policy for enforcement, and produces inequitable results.

Purchaser contracts to purchase realty from seller for $4 million, agreeing to liquidate damages so that seller may retain a $250,000 earnest money deposit if purchaser subsequently defaults. Eight months later, purchaser breaches and seller resells the property to a third party for $5 million. Seller must refund the $250,000 to the purchaser-in-default.

Contract law helps parties pursue a nearly unlimited variety of bargains by providing legal sanctions to enforce private agreements. Yet the risk of undercompensation restricts access to the benefits of many bargains. To overcome the constraints of the enforcement process, parties can predetermine the damage of a broken promise. Real estate contracts, therefore, usually include liquidated damages clauses1 permitting the seller to retain certain payments as liquidated damages if the purchaser fails to complete the transaction.2

In Lind Building Corp. v. Pacific Bellevue Developments,3 a Washington court considered whether a seller of realty may retain a breaching purchaser's deposit as liquidated damages when it appears that the seller sustained no actual damages from breach. Holding that a liquidated damages clause is unenforceable when there is "no actual loss,”

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1. Liquidated damages clauses fix the amount of damages breaching parties must pay in lieu of performance. "Liquidated damages" refers to the legal conclusion that one such clause is enforceable, as distinguished from a penalty. Liquidated damages clauses may also be called "agreed damages" or "stipulated damages" to avoid confusing them with clauses already deemed enforceable. See, e.g., Sweet, Liquidated Damages in California, 60 CALIF. L. REV. 84, 84 (1972). This Note uses the term "liquidated damages clauses" because of its popularity.


the first division Court of Appeals announced significant additions to Washington's liquidated damages law.4

The Lind defense of "no actual injury" eradicates the benefits of liquidating damages. When ordinary remedial measures for breach would yield no damages at trial, the defense voids otherwise enforceable clauses. By preventing parties from relying on their negotiated clauses, the defense diminishes the advantages of agreed remedies without delivering reciprocal gains in equity. A no actual injury defense, therefore, contravenes Washington's long standing policy of favoring liquidated damages clauses. To preserve the utility of liquidated damages clauses, courts should reject the Lind defense and judge enforceability as of the time of contract formation.

I. UTILITY OF LIQUIDATING DAMAGES

There are numerous reasons why contracting parties attempt to predetermine the amount of damages that will be awarded upon breach. When parties can be certain that courts will enforce their liquidated damages clauses, the advantages of relying on such clauses accrue throughout three phases of contract: formation, breach, and enforcement.5

Allowing parties to predetermine the remedies for a broken promise enables them to allocate business risks during contract formation. First, by negotiating the amount at which to fix damages, parties learn the nature and range of harm a breach might cause, thus enabling them to weigh the gains from performance against the costs of breach. Parties can avoid excessive risk by bargaining for more favorable terms before accepting contract liability. Second, stipulating damages helps promisees identify the most reliable promisors with whom to contract.6 Finally, stipulating damages allows parties to reduce the

5. Courts "enforce" liquidated damages clauses by upholding them when injured parties bring suits on contracts to recover liquidated damages and by denying claims for restitution of payments brought by plaintiffs-in-default. See, e.g., WASH. REV. CODE § 62A.2-718(1)–(2) (1989).
6. By agreeing to generous liquidated damages clauses, unknown promisors enhance their credibility and enable promisees to offset the added risk of contracting with unestablished entities. R. Posner, ECONOMIC ANALYSIS OF LAW 116 (3d ed. 1986). Stipulating damages to signify reliability has particular application to earnest money agreements. Buyers pay earnest money at the time of contract to indicate their intention and ability to perform. BLACK'S LAW DICTIONARY 456 (5th ed. 1979).
risk of undercompensation by enhancing measures of recovery where ordinary legal measures would be inadequate.\(^7\)

Liquidated damages clauses help parties decide when breach is efficient. The theory of efficient breach holds that, all other factors being equal, parties should breach contracts and apply resources towards more advantageous opportunities when expected gains from breach exceed the expected costs.\(^8\) The uncertainty of litigation makes predicting precisely when breach has become an efficient alternative extremely difficult. When parties are certain that courts will uphold their liquidated damages clauses, however, the cost of breach is fixed and they can identify more accurately the point at which breach becomes efficient.\(^9\)

Liberal enforcement of liquidated damages clauses allows parties to avoid the risks of litigation.\(^{10}\) Parties typically use liquidated damages clauses to replace the speculative nature of jury awards with amounts they presume will compensate innocent parties.\(^{11}\) Fixing damages also reduces the risk of nonrecovery where the indeterminate nature of a loss would make proof difficult or impossible.

Liberal enforcement also promotes more efficient dispute resolution.\(^{12}\) First, valid liquidated damages clauses save parties the expense and delay of preparing for and litigating complicated damages issues, and save the time of judges, juries and witnesses.\(^{13}\) Second, favoring

\(^7\) Allowing parties to alter legal measures of damages may prompt parties to enter bargains that potentially inadequate recoveries might otherwise discourage. See Clarkson, Miller & Muris, Liquidated Damages v. Penalties: Sense or Nonsense?, 1978 Wis. L. Rev. 351, 367 [hereinafter Clarkson].

\(^8\) See, e.g., R. Posner, supra note 6, at 107. Encouraging breach when it might lead to efficient use of resources is a primary rationale for the penalty limitation. See Note, Liquidated Damages as Prima Facie Evidence, 51 Ind. L.J. 189, 190–92 (1975).

\(^9\) Some commentators argue that courts should not enforce liquidated damages clauses whose sums greatly exceed actual damages because enforcing such clauses creates incentives for non-breaching parties to induce breach in undetectable ways. See Clarkson, supra note 7, at 368–70. Spending resources on breach-inducing activities and preventing breach inducement is wasteful. Id. at 370–72. This analysis has little application to realty transactions. Parties can complete them with minimal cooperation or assistance from the other side, thus reducing opportunities to induce breach. The argument is criticized in Rea, Efficiency Implications of Penalties and Liquidated Damages, 13 J. LEGAL STUD. 147, 166 (1984).

\(^10\) Sweet, supra note 1, at 87.


\(^13\) Washington courts have favored liquidated damages clauses to expedite litigation since Reichenbach v. Sage, 13 Wash. 364, 369, 43 P. 354, 355 (1896).
liquidated damages clauses increases the likelihood of pretrial settlements. ¹⁴

II. THE LAW OF LIQUIDATED DAMAGES IN WASHINGTON

Absent a controlling statute, Washington courts determine the validity of liquidated damages clauses in all types of contracts according to the same legal doctrines. ¹⁵ Several policy considerations influence how courts treat liquidated damages provisions. Lind, which adopted a "no actual injury" defense to liquidated damages recovery, significantly altered the tests Washington courts use to determine the enforceability of liquidated damages clauses.

A. Courts Favor True Liquidated Damages Clauses

A distinguishing feature of contract law is the freedom it gives parties to control the substantive legal aspects of their dealings. In Washington, contractual freedom allows parties to predetermine the amount of damages payable for a broken promise. ¹⁶ To successfully challenge a liquidated damages clause, a litigant must assert and prove that the clause functions as a penalty and, therefore, falls within an exception to the general rule of enforceability. ¹⁷

The penalty limitation incorporates two important policy considerations—equity and intent. First, courts will not enforce inequitable clauses. ¹⁸ Second, parties must intend to liquidate damages as fair and

¹⁴. See Comment, supra note 12, at 1058. Parties are inclined to settle disputes when each side expects similar results from litigation. The amount of damages likely to be awarded at trial is a common cause of misalliance. Fixing the value of damages at contract formation makes the outcome of a trial more predictable, and settlement becomes more likely. Id.; see also R. Posner, ECONOMIC ANALYSIS OF LAW 338-39 (1972).


¹⁶. See Walter Implement, Inc. v. Focht, 107 Wash. 2d 553, 558, 730 P.2d 1340, 1343 (1987) (true liquidated damages clauses favored); see also Management, Inc. v. Schassberger, 39 Wash. 2d 321, 326, 235 P.2d 293, 297 (1951) ("We are loathe to interfere with the rights of parties to contract as they please between themselves . . . .")

¹⁷. "Penalty" is defined as a stipulated sum payable on breach of contract, irrespective of the damages sustained, as a punishment for default. It operates as in terrorem of the offending party rather than as a measure of compensation for breach. See Management, Inc., 39 Wash. 2d at 326, 235 P.2d at 296 (quoting definition from 15 AM. JUR. DAMAGES § 241 (1938)).

¹⁸. Courts consider various factors in deciding whether a clause is inequitable: the relative bargaining position of the parties, e.g., Focht, 107 Wash. 2d at 558, 730 P.2d at 1343; violation of the principles of unconscionability, e.g., Artz v. O'Bannon, 17 Wash. App. 421, 427, 562 P.2d 674, 677 (1977); evidence of fraud, illegality, or overreaching, e.g., Madler v. Silverstone, 55
reasonable compensation. In deciding whether parties intended a fixed sum as compensation rather than a penalty, neither the descriptive language in the clause nor the fact that such a clause was included is controlling; yet both factors are seriously considered.

B. Distinguishing Liquidated Damages From Penalties

Washington courts distinguish valid liquidated damages clauses from penalties by applying two tests: a test of reasonableness and a test of uncertainty. Specifically, a clause must fix damages at an amount which represents a reasonable forecast of just compensation for the harm caused by the breach, and the harm caused by the breach must be incapable of ascertainment or very difficult to prove.

I. Reasonableness of Forecasted Damages

The purpose of the reasonableness test is to decide whether a liquidated damages clause sets damages at an amount that is fair in relation to the breach. The test contains two basic components: a timing feature which gives courts a perspective from which to evaluate fairness, and a rule of proportion defining the boundaries within which an amount or formula can be considered fair compensation for breach.

The time of contract formation is generally accepted as the appropriate point from which to judge the reasonableness of a stipulated

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19. *See Focht, 107 Wash. 2d at 558–59, 730 P.2d at 1343. The intent standard, once a primary element in evaluating liquidated damages clauses, has largely been replaced by reasonableness and uncertainty tests.


21. *Focht, 107 Wash. 2d at 559, 560, 730 P.2d at 1344 (invalidating an unreasonable clause in an equipment lease where damages were not difficult to ascertain). The reasonableness and uncertainty criteria are based on section 339(1) of the first Restatement of Contracts. Section 339(1) provides that liquidated damages clauses are not enforceable unless: "(a) the amount so fixed is a reasonable forecast of just compensation for the harm that is caused by the breach, and (b) the harm that is caused by the breach is one that is incapable of very difficult of accurate estimation." *RESTATEMENT OF CONTRACTS § 339(1) (1932) (adopted in Washington by Management, Inc., 39 Wash. 2d at 327–28, 235 P.2d at 297). These criteria are consistent with the salient features of earlier tests. *See Madler, 55 Wash. at 165, 104 P. at 167 (enforcing the forfeiture of $500 earnest money where the stipulated sum was not so disproportionate to the probable damages suffered as to appear unconscionable and damages from breach were uncertain in nature).

22. Courts rely on the reasonableness test to eliminate penalties because equitable policies prevent enforcement of unconscionable clauses and those that disregard principles of compensation. *See supra notes 18–20 and accompanying text.
amount or formula. Washington courts have adopted this perspective approach.

To be fair, a clause must not fix damages at an amount disproportionate to the probable actual damages. Courts applying this requirement typically address two issues: whether the stipulated amount bears a reasonable relation to actual damages, and whether the parties attempted to make a genuine pre-estimate of just compensation for damages anticipated from breach. A negative response to either inquiry ordinarily precludes enforcement of a clause.

Courts have identified two factors to consider in addressing these issues. First, a clause should regulate the stipulated amount or formula so that forecasted damages will be commensurate with the

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23. See 5 A. Corbin, Corbin on Contracts § 1059 (1964). Three perspectives from which to judge reasonableness are: a time of contract approach, which upholds a clause if the stipulated sum was reasonable when made, regardless of the damages actually suffered, see, e.g., infra note 24 (discussing Restatement of Contracts § 339(1) (1932)); a time of contract or trial approach, which upholds a clause if the stipulated sum corresponds to either anticipated or actual damages, see, e.g., infra notes 58, 65 (discussing Restatement (Second) of Contracts § 356(1) (1979)); and a time of contract and trial approach, which upholds a clause only if the stipulated sum corresponds to both anticipated and actual damages; see, e.g., infra notes 59, 65 and accompanying text (discussing the no actual injury defense). This Note refers to the first two methods as prospective or time of contract approaches, and the third method as a retrospective or trial approach.

24. E.g., Focht, 107 Wash. 2d at 559, 730 P.2d at 1343 (reasonableness of forecast judged as of the time contract was entered). But see infra notes 59, 65 and accompanying text (Lind rejects prospective approach). Restatement section 339(1) embodies the prospective approach. See Restatement of Contracts § 339(1) illustration 7 (1932) (evidence of no actual harm wholly immaterial).


28. See C. McCormick, supra note 11, at § 149.
gravity of expected actual harm. Second, forecasted sums should set damages at levels the parties expect will be compensatory.

2. 

Uncertainty of Damages

The uncertainty test requires that the harm from breach be incapable of ascertainment or very difficult to prove. However, the specific criteria of Washington's uncertainty test remain somewhat ambiguous because courts enunciate the test in various ways. As a result, courts applying the test often reach inconsistent results.

Generally, the uncertainty test is satisfied in one of two ways. Courts often hold that uncertainty requires that neither contract law nor the agreement furnish a formula for computing damages. Alternatively, regardless of whether a damages formula exists, some courts

29. For example, where a contract requires performance or non-performance of several acts of varying degrees of importance, and a clause stipulates the same amount to be paid for the breach of any or all of these acts, then unless the stipulated amount would provide reasonable compensation for any combination of breaches, courts routinely find a penalty because the provision bears no reasonable relation to actual damages. See, e.g., Sledge v. Arcadia Orchards Co., 77 Wash. 477, 482-85, 137 P. 1051, 1053-54 (1914).

Similarly, in contracts to perform a specific act, a clause should adjust damages according to the severity or extent of breach. Failure to do so often accounts for a court's refusal to enforce liquidated damages clauses in long term executory contracts, such as covenants not to compete, construction contracts and equipment leases. See Management, Inc. v. Schassberger, 39 Wash. 2d 321, 330-31, 235 P.2d 293, 298-99 (1951) (clause fixing damages at $10,000 for breach of a covenant not to compete was unreasonable in the light of the severity of the anticipated breach); see also Walter Implement, Inc. v. Focht, 107 Wash. 2d 555, 560-61, 730 P.2d 1340, 1344 (1987).

30. The size of an agreed sum relative to contract price is not controlling on the reasonableness issue. See Pettet v. Wonders, 23 Wash. App. 795, 801-02, 599 P.2d 1297, 1301 (1979). Courts tend to enforce clauses when evidence of negotiations indicates that the parties agreed that breach would likely cause the stipulated amount of damages. See, e.g., Underwood, 63 Wash. 2d at 367, 387 P.2d at 370 (clause contained a reasonable forecast of just compensation where "parties spent more time discussing the amount of the earnest money 'than anything else'"). Adhesion contracts, therefore, are naturally suspect.

31. Focht, 107 Wash. 2d at 559, 730 P.2d at 1343. Requiring that harm be uncertain reflects a policy of favoring liquidated damages clauses where they will likely increase the efficiency of resolving contractual disputes. See A. Corbin, supra note 23, at § 1060.

32. Four versions of Washington's uncertainty test require the harm from breach to be "incapable or very difficult of ascertainment," Focht, 107 Wash. 2d at 559, 730 P.2d at 1343; "incapable or very difficult of accurate estimation," Management, Inc., 39 Wash. 2d at 328, 235 P.2d at 297; "reasonable in the light of the . . . difficulties of proof of loss," Wash. Rev. Code § 62A.2-718(1) (1989); or "uncertain in their nature and are not readily susceptible of proof by the ordinary rules of evidence," Madler v. Silverstone, 55 Wash. 159, 165, 104 P. 165, 167 (1909).

33. See, e.g., Focht, 107 Wash. 2d 553, 730 P.2d 1340 (1987). Arguably, the tests create a conundrum if uncertainty requires that there be no damages formula in the contract because a valid clause must formulate a reasonable relation between estimated and actual damages. See Sperry & Snyder, Liquidated Damages Clauses in Real Estate Purchase Agreements—Are They Enforceable?, 18 REAL PROP. PROB. & TR. NEWSL. 5 (1990). For a discussion of how assessing uncertainty as of contract formation may avoid this dilemma, see infra notes 60-64 and accompanying text. It is important to note, however, that the uncertainty test is rarely
find uncertainty where the precise amount or extent of damages is difficult to ascertain or prove.\textsuperscript{34}

The time at which damages must be uncertain is not clear. The Washington Supreme Court has not stated whether uncertainty of damages is to be measured as of the time of contract, the time of breach, or the time of trial. The most common approach, that of Restatement of Contracts section 339(1), focuses on the time of contract.\textsuperscript{35} By adopting section 339(1), Washington courts have likely made contract formation the proper vantage point for testing the uncertainty of damages.\textsuperscript{36}

C. The Role of Actual Injury in Resolving Enforceability

Once courts decide that liquidated damages clauses satisfy the tests of reasonableness and uncertainty, they typically award the stipulated amounts regardless of whether those sums are greater or less than the innocent parties' actual injuries.\textsuperscript{37} In contrast, when a clause is a penalty, parties may recover only those damages they can prove were actually sustained.\textsuperscript{38} The controversial question is what role, if any, should the amount of injury actually suffered play in determining whether clauses satisfy the reasonableness and uncertainty tests.\textsuperscript{39}

I. The Role of Actual Injury Prior to Lind

Before Lind, Washington courts viewed evidence of actual harm as either irrelevant\textsuperscript{40} or relevant only insofar as it provided proof of the damages parties might reasonably have expected breach to cause at the
determinative and has frequently been criticized. \textit{E.g.}, Grand Union Laundry Co. v. Carney, 88 Wash. 327, 331–32 153 P. 5, 6–7 (1915).


35. Although a time frame for the uncertainty test is absent from the language of RESTATEMENT § 339(1), the illustrations indicate that the time of contract is the appropriate vantage point. \textit{See RESTATEMENT OF CONTRACTS} § 339(1) illustrations 3, 7 (1932).

36. Moreover, the Focht court explicitly followed the reasoning of an Ohio court which stated that uncertainty must be determined “at the time of the execution of the contract.” \textit{Focht}, 107 Wash. 2d at 561, 730 P.2d at 1344 (following American Fin. Leasing & Servs. Co. v. Miller, 41 Ohio App. 2d 69, 322 N.E.2d 149, 152 (1974)). For cases implying that uncertainty be measured at the time of trial, see \textit{Madler}, 55 Wash. at 165, 104 P. at 167; \textit{see also infra} notes 57–58 and accompanying text (discussing Lind).


40. \textit{See Mead}, 33 Wash. 2d at 756, 207 P.2d at 235; \textit{see also} Erickson v. Green, 47 Wash. 613, 615, 92 P. 449, 450 (1907) (testimony that defendant suffered no actual injuries was immaterial
time of contract. As a result, courts did not require innocent parties to prove actual injuries to recover under liquidated damages clauses.


In *Lind*, Lind Building Corporation (Lind) agreed to buy real estate from Pacific Bellevue Developments (PBD) for nearly $4.15 million. The earnest money agreement provided: “If Purchaser defaults, Seller shall have the right to receive the Deposit from escrow and retain it as liquidated damages . . .”

The events leading up to the suit were as follows. Rounding and simplifying, Lind made payments totalling $250,000 as deposits and as consideration for the right to extend the closing date by four months. First, Lind paid $20,000 as an initial deposit upon execution of the agreement. Pursuant to the agreement, Lind paid an additional deposit of $20,000 to extend the contingency period by thirty days, and then paid $50,000 more when the contingencies were removed.

and properly excluded). Evidence of injuries actually suffered is irrelevant because it cannot help establish reasonableness or uncertainty without violating the prospective approach.

The *Pettet* court analyzed the role of actual injury in enforcing a liquidated damages clause in an earnest money agreement. Although reversing the trial court on other grounds, the First Division Court of Appeals held that the trial court did not err by excluding testimony indicating that the seller was not actually injured. The court stated:

The trial court refused to admit testimony concerning the later sale of the business by the sellers to third parties, allegedly for some $23,000 more than the buyer in this case had agreed to pay for it. So far as the sellers' case was based on the liquidated damages clause, we cannot say that the trial court abused its discretion in this regard since the test of reasonableness under such a clause looks to the time that the agreement was entered. *Pettet v. Wonders*, 23 Wash. App. 795, 802, 599 P.2d 1297–1301 (Div. 1 1979). *Contra Lind Bldg. Corp. v. Pacific Bellevue Devs.*, 55 Wash. App. 70, 71, 776 P.2d 977, 978–79 (Div. I), review denied, 113 Wash. 2d 1021, 781 P.2d 1322 (1989).

41. Judging from the time of contract, the amount of “actual” injury parties might incur is relevant because it helps courts decide whether a stipulated amount bears a reasonable relation to expected actual injuries. See Northwest Collectors, Inc. v. Enders, 74 Wash. 2d 585, 593–95, 446 P.2d 200, 205–06 (1968) (clause in an equipment lease was a penalty where it required payment of the full contract amount whether breach was total or partial because the fixed amount bore no reasonable relation to potential actual damages); see also *Smith*, 109 Wash. at 534–35, 187 P. at 364; Brower Co. v. Garrison, 2 Wash. App. 424, 432–35, 468 P.2d 469, 475–77 (1970).

42. See, e.g., American Copper, Brass & Iron Works v. Galland-Burke Brewing & Malting Co., 30 Wash. 178, 187–88, 70 P. 236, 239 (1902) (reversible error to admit hearsay evidence that aggrieved party suffered no actual injury and to instruct jury that aggrieved party was required to show evidence of actual injuries).


44. Id.

45. Id. at 71–72, 776 P.2d at 978–79.

46. Id. at 71, 776 P.2d at 978.

47. Id. at 71, 776 P.2d at 978–79.
Lind paid the remaining $160,000 toward the purchase price incrementally to extend the closing date.\textsuperscript{48}

Eight months after executing the contract, Lind failed to complete the transaction by the amended closing date and PBD notified Lind that it had forfeited its $250,000 deposit.\textsuperscript{49} A month later, PBD resold the property to a third party for $1 million more than Lind had agreed to pay for it.\textsuperscript{50}

Lind sued PBD to recover all deposit payments that PBD retained as liquidated damages upon Lind's failure to complete the transaction. At issue in \textit{Lind} was whether the seller was entitled to keep the $250,000 as liquidated damages. The trial court ruled that it was and enforced the liquidated damages clause.\textsuperscript{51} The First Division Court of Appeals reversed the trial court's ruling and held that the clause was a penalty.\textsuperscript{52}

The appellate court in \textit{Lind} reconsidered the proper role of actual injury in determining enforceability of liquidated damages clauses. The court held that where it appears at trial that the party seeking to uphold the clause has suffered "no actual substantial damages, the requirement . . . that the amount of liquidated damages be reasonable in the light of the anticipated or actual loss cannot be satisfied."\textsuperscript{53}

The Court of Appeals gave three reasons for deciding that the liquidated damages clause was unenforceable.\textsuperscript{54} The court's second reason, that liquidated damages clauses will not be enforced where there are no actual substantial damages, adds a requirement of substantive significance to Washington's previous formula for valid liquidated dam-

\textsuperscript{48} \textit{Id.} at 72, 776 P.2d at 979.
\textsuperscript{49} \textit{Id.}
\textsuperscript{50} \textit{Id.}
\textsuperscript{51} \textit{Id.}
\textsuperscript{52} \textit{Id.} at 82, 776 P.2d at 984.
\textsuperscript{53} \textit{Id.} at 77, 776 P.2d at 982.
\textsuperscript{54} The court stated that:

There are three reasons the liquidated damages clause in this case is unenforceable. The amount of $250,000 came into existence for reasons unrelated to a provision calling for liquidated damages and, therefore, does not represent an effort by the parties to make a reasonable forecast of anticipated damages. \textit{The second reason is that, there being no actual substantial damages, the requirement of the rule that the amount of liquidated damages be reasonable in the light of the anticipated or actual loss cannot be satisfied.} Thirdly, calculation of the amounts [seller] claims represent losses due to [purchaser's] default are not difficult of ascertainment or proof. \textit{Id.} at 77, 776 P.2d at 981-82 (emphasis added). The court's first and third reasons are not discussed in this Note.
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ages clauses.\textsuperscript{55} *Lind* creates a new liquidated damages doctrine—a “no actual injury” defense.\textsuperscript{56}

In support of a no actual injury defense, the *Lind* court relied primarily on three authorities.\textsuperscript{57} These authorities apply the defense in two distinct manners: first, the *Restatement (Second) of Contracts* section 356(1) requires that damages be uncertain at the time of trial;\textsuperscript{58} second, some courts require that stipulated amounts be reasonable at the time of trial.\textsuperscript{59}

III. A CRITIQUE OF THE NO ACTUAL INJURY DEFENSE

By relying on two different approaches to the no actual injury defense, the *Lind* court offers little guidance on how courts should apply the defense. Regardless of how the defense is applied, however, it restricts or at least discourages the use of liquidated damages clauses in many situations and negates the practical benefits of using liquidated damages clauses.

\textsuperscript{55} Arguably, the court went further than required in adopting a no actual injury defense. Each of the court’s first and third rationales was a sufficient basis for its decision.

\textsuperscript{56} The court stated: “the weight of authority and the better-reasoned cases hold that where there is no actual loss, an otherwise enforceable liquidated damages clause is not enforceable because to do so would violate the principle that damages should be compensatory only.” *Lind*, 55 Wash. App. at 78, 776 P.2d at 982. This defense is difficult to apply because the opinion fails to distinguish between no actual damages and no actual loss. “Actual damages” is a term of art meaning “the nature of injury for which recovery is allowed.” BLACK’S LAW DICTIONARY 33 (5th ed. 1979). Actual “loss,” however, may be a generic term meaning any harm, injury or deprivation whether or not it would be legally compensable. See *id.* at 851–52. Labeling the defense a “no actual injury” defense attempts to avoid a built-in legal conclusion.


\textsuperscript{58} Section 356 provides in part:

(1) 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.

RESTATEMENT (SECOND) OF CONTRACTS § 356(1) (1981). Under § 356(1), if “it is clear that no loss at all has occurred, a provision fixing a substantial sum as damages is unenforceable” because damages are not difficult to prove. See *id.* at comment b; see also *id.* illustration 4 (if there has been no actual injury, the clause is a penalty because the actual loss is not difficult to prove); Note, Liquidated Damages Recovery Under the Restatement (Second) of Contracts, 67 CORNELL L. REV. 862, 874–75 (1982).

\textsuperscript{59} The *Norwalk* court held that a clause must be reasonable at the time of contract and also at the time of trial. *Norwalk*, 220 A.2d at 268. Under *Norwalk*, if it appears at trial that a breach caused no harm, an agreement for damages in excess of a nominal amount is unreasonable and the clause will not be enforced. *Id.* Similarly, the *Hubbard* court allowed a contesting party to defeat a clause by proving that agreed damages were disproportionate to the damages actually suffered. *Hubbard*, 649 F. Supp. at 1316–17.
A. Preserving the Utility of Liquidated Damages Clauses

To preserve the practical benefits of liquidating damages, courts must assess both the uncertainty of damages and the reasonableness of stipulated amounts as of the time of contract formation—not the time of trial.

1. Uncertainty of Damages Must Be Judged as of Contract Formation

When judged as of the time of contract, requiring that the amount or extent of damages be uncertain presents no major obstacle to enforceability. Rarely can contracting parties predetermine precisely or within a narrow range the amount of damages that would flow from breach. Unpredictable market fluctuations and variations in the severity of possible breaches make ascertaining the amount of potential damages nearly impossible. Because of the ease with which the prospective uncertainty test can be satisfied, courts properly shift their emphasis to the reasonableness test to distinguish true liquidated damages clauses from penalties.

Conversely, measuring uncertainty at trial dramatically reduces the efficacy of liquidated damages clauses by forcing courts to treat many reasonable clauses as penalties. Requiring uncertainty at trial invalidates any clause where the amount of damages is then certain or can be easily calculated, regardless of the reasonableness of the fixed amount. Where the law furnishes a standard for computing damages, the amount will seldom be incapable of ascertainment or very difficult to prove at trial. In contracts for the sale of goods or real estate, for example, damages are often measured by the difference between the contract price and market value at the time of breach; therefore, damages at trial can often be accurately computed. Requiring that the amount of damages be uncertain at the time of trial, therefore, precludes the use of liquidated damages clauses in many sales contracts.

61. See, e.g., WASH. REV. CODE § 62A.2-708 (1989). See also infra note 82 (damages measure in sales of realty). In real estate contracts, market value may be presumed from further transactions or established by appraisal. C. MCCORMICK, supra note 11, at §§ 44-45. In sales of goods, if no market exists or market value is difficult to prove, evidence of substitute prices is admissible, as is opinion evidence. See WASH. REV. CODE ANN. §§ 62A.2-708 comment 1, 2-723, 2-724 (1966).
62. In California, parties to goods contracts may liquidate damages only when the goods have a special value or purpose because agreed remedies are invalid if damages may be conveniently computed at the time of breach or trial. See Sweet, supra note 1, at 106. Florida law yields similar results in contracts for the sale of real estate because after breach, the value of the land is
Such categorical invalidation is especially troublesome in real estate transactions where the availability of specific performance assumes that parties assign different values to the same realty.

Where uncertainty requires that there be no ascertainable damages formula, judging uncertainty at trial rather than contract formation will invalidate many reasonable clauses. Parties frequently bargain for a number of performances, any of which might be fulfilled to varying degrees. Because complex agreements contemplate many combinations of breaches, and hence several possible losses, defining proper measures of damages can be very difficult at contract execution. At the time of trial, however, courts seldom lack an appropriate formula for measuring damages. Indeed, only when the nature and severity of a breach are known, can the proper measure of damages be ascertained.

Courts that distinguish penalties by measuring the uncertainty of damages at the time of trial will be forced to disallow liquidated damages in many contractual settings. In such cases, the social benefits of liquidating damages are completely lost. Judging uncertainty at the time of trial gives the uncertainty test overwhelming force, which is at odds with Washington’s policy of favoring liquidated damages clauses.

2. Reasonableness of Forecasts Must Be Judged as of Contract Formation

To maximize the practical benefits of liquidating damages, courts must evaluate the reasonableness of agreed remedies at the time of contract, not at the time of breach or trial. Although a wide disparity between the amount of damages stipulated and those actually suf-
ferred may be evidence that a forecast was unreasonable when made, it should never be dispositive.

a. Liquidating Damages To Apportion Risk

Reasonableness must be judged as of contract formation to afford parties the advantage of managing business and litigation risks. Using this prospective approach, courts recognize that parties to liquidated damages clauses do not expect their estimates of damages to be exact. During negotiations, parties agree to fix damages at the amount of expected losses to reduce the risk that breach will leave them undercompensated. When parties believe that their genuine pre-estimates of damages will be enforced, they can allocate risk burdens in exchange for adjustments to the contract price.

On the other hand, judging reasonableness at the time of trial prevents parties from effectively predetermining remedies. Reasonableness at trial requires estimated damages to approximate damages in fact sustained, whether or not forecasts were reasonable when made. Therefore, if circumstances change unexpectedly following contract formation and injuries suffered are disproportionate to sums stipulated, courts will not enforce the liquidated damages clauses, claiming they are unreasonable.

In certain cases, therefore, allocations of risk that were reasonable when made will be ineffectual when reasonableness is assessed at the time of trial. Where a primary purpose behind liquidating damages is to allocate risk, the clauses may go unused for fear that failure to anticipate damages accurately will lead to a waste of resources. In more extreme cases, parties may refrain from certain contracts altogether rather than accepting the risk of undercompensation.

b. Liquidating Damages To Resolve Disputes Efficiently

Assessing the reasonableness of stipulated sums as of contract formation improves the efficiency of resolving contractual disputes by reducing the number of litigable issues. Actual injury is irrelevant

66. See supra notes 40-41 and accompanying text (discussing the role of actual injury prior to Lind).
67. See supra notes 5-7, 10-11 and accompanying text (utility of liquidated damages clauses).
68. "[S]eller, in making an earnest money agreement, can simply demand more protection—a larger deposit of earnest money—or even dispense with a liquidated damages provision altogether." Mahoney v. Tingley, 85 Wash. 2d 95, 100, 529 P.2d 1068, 1071 (1975). The Mahoney court assumed seller preferred the certainty of a liquidated damages clause to the risk of seeking actual damages and that purchasers understood and relied upon the liability limitation in the clause. Id. at 99-100, 529 P.2d at 1071.
69. See Clarkson, supra note 7, at 367.
under the prospective approach except perhaps as evidence of the amount of damages parties might have reasonably anticipated.\textsuperscript{70} Parties and courts save valuable resources. In contrast, when reasonableness requires that stipulated sums approximate injuries actually suffered, parties must fully litigate (at great expense and delay) that which they sought not to litigate. Indeed, where the amount at stake is low, the cost of resolving actual injury issues might exceed the benefits of the bargain, thus deterring contract enforcement.

Assessing reasonableness as of contract formation also creates incentives for parties to settle. To encourage out-of-court settlements, liquidated damages laws must minimize disparities between the results each side expects from litigation\textsuperscript{71} and make clauses harder to challenge under the penalty doctrine.\textsuperscript{72} Prospective reasonableness furthers these dual aims by expanding the range of enforceability. Instead of upholding only estimates that approximate actual harm, the prospective approach upholds estimates that are reasonable in the light of anticipated or actual losses. Increasing the likelihood that clauses will be enforced makes them less susceptible to challenge and harmonizes parties' expected outcomes.

\textbf{B. Courts Should Reject the No Actual Injury Defense}

Courts should reject the no actual injury defense because it negates many of the practical benefits of liquidated damages clauses. This retrospective look at agreed remedies could ultimately leave many if not most liquidated damages clauses open to attack. Furthermore, the defense turns on an arbitrary test and leads to the very inequitable results it was meant to avoid.

\textbf{1. The Defense Negates the Utility of Liquidated Damages Clauses}

The no actual injury defense negates certain practical benefits of fixing damages by requiring both uncertainty and reasonableness at the time of trial.\textsuperscript{73} First, to the extent that parties believe the defense might apply to their contracts, they are likely not to attempt to liquidate damages, thus sacrificing the social gains of expedient dispute res-

\begin{itemize}
  \item \textsuperscript{70} See supra notes 40-41 and accompanying text (discussing the role of actual injury prior to \textit{Lind}).
  \item \textsuperscript{71} If each side expects substantially different results from litigation, parties will reach an impasse in settlement negotiations.
  \item \textsuperscript{72} To the extent that a clause is arguably a penalty, the clause may itself be challenged and function as an impediment to settlement.
  \item \textsuperscript{73} See supra notes 57-59 and accompanying text (discussing time frame of no actual injury defense).
\end{itemize}
olution. Second, although the defense is intended to be an exception to the general rule of enforceability, it could lead to a more generalized use of the retrospective approach, thereby compounding losses in utility and efficiency.

Although the *Lind* court conceded that Washington courts have not required claimants to prove actual damages to recover liquidated damages, permitting contestants to assert a no actual injury defense might indeed have that effect. By allowing the focus to shift from anticipated to actual damages, courts could emphasize the retrospective approach in a substantial number of cases, consequently preventing parties and the judiciary from realizing the full benefits of agreed remedies.

2. The Defense Imposes an Arbitrary Test

Courts should also reject the no actual injury defense because it is an arbitrary restriction on liquidated damages clauses. The *Lind* court sought to justify the defense on the basis of substantive fairness. In theory, defining reasonableness as substantive fairness allows courts to base enforcement decisions on the fundamental remedial principle of contract law—just compensation. Assuming that compensatory damages are a fair measure of actual harm, the no actual injury defense is arbitrary because it selectively invokes compensatory principles to invalidate certain liquidated damages clauses. Strict compensation alone can provide a principled policy in support of the defense only if uniformly applied to liquidated damages clauses. Yet, the *Lind* defense nullifies only clauses that overliquidate damages when the damages suffered are nominal.

The arbitrariness of a no actual injury defense is illustrated by two Washington cases where noncompensatory liquidated damages clauses were enforced: the first upholds an underliquidated damages clause; the second awards overliquidated damages. In *Mahoney v. Tingley*, a divided appellate court held that vendors of property who agreed to fix damages at $200 in an earnest money contract were entitled to recover their actual damages of $3,140 because the applicable measure of damages was reasonably capable of ascertainment. The supreme court reversed, holding that where a stipulated sum limits the injured


75. Refusing to enforce all clauses whose awards deviate from the measure of compensatory damages at trial, however, would eradicate predetermined remedies from the law of contract.

party's loss there is no penalty, though the result is noncompensatory. 77

Jennings v. McCormick presented the opposite situation. 78 The plaintiff sought recovery of $200 loaned to defendants to construct a dike. A clause provided for recovery of that sum as liquidated damages if defendants injured plaintiff's dike during construction. Based on the trial court's instruction to award actual damages suffered up to $200, the jury awarded plaintiff $100. The supreme court reversed, holding that because the agreement was for liquidated damages, the recovery should have been fixed at $200, the amount upon which the parties agreed. 79

Assuming that parties satisfy the tests of reasonableness and uncertainty at the time of contract, Mahoney would enforce a clause even though actual injury greatly exceeds the agreed amount. Consequently, injured parties would be undercompensated. Jennings suggests a tolerance for overcompensation so long as the amount is not so excessive as to be unconscionable. 80 In contrast, when breach causes no injury, Lind's defense arbitrarily voids any overcompensatory clauses. To the extent that courts relieve parties of bad bargains only when they lead to overcompensation, compensatory principles fail to justify a bright line defense at "no actual injury." 81

3. The Defense Produces Inequitable Results

The no actual injury defense leads to results that violate the very principles of equity the Lind court purportedly sought to further. This inequity results from a flaw in the basic premise of the no actual injury defense—that where a legal definition of damages yields a value of zero, breach caused no actual "loss." When legal definitions of recognizable harm prove too narrow to fully indemnify all remedial interests in certain contracts, invalidating liquidated damages clauses on the grounds of overliquidation deprives parties of complete relief. Indeed, in real estate transactions, aggrieved sellers often suffer very real injury even if they ultimately sell their property at or above original contract prices.

Lind illustrates that real estate purchase and sale agreements present a situation in which legal definitions of actual harm are unduly

79. Id. at 429, 65 P. at 765.
81. Lind's defense is arbitrary not only because it allows undercompensation, but also because it allows overcompensation so long as actual injury exceeds zero.
restricted. The general legal measure of damages for loss of a bargain to purchase or sell real estate is the contract price minus market price at the time of breach.\textsuperscript{82} Accordingly, any time innocent sellers achieve equal or higher prices in later transactions, the no actual injury defense compels them to relinquish deposits. To fully compensate innocent sellers, however, courts must look beyond standard measures of damages to see that all legitimate contract interests are protected.

The general loss-of-bargain measure ignores several protectable contract interests.\textsuperscript{83} First, the standard measure fails to compensate sellers for allowing potential buyers to hold salable property off the market prior to closing. Much like option contracts, earnest money agreements give buyers the right to purchase property and prohibit sale to third parties for a specified time.\textsuperscript{84} However, sellers of options receive valuable consideration whether or not buyers exercise their right to purchase, whereas under \textit{Lind}, sellers using earnest money agreements receive no compensation unless the market value of their property declines. Thus, in strong property markets, earnest money buyers can force sellers to hold salable property off the market for the term of the agreement and refuse to close sales with impunity.\textsuperscript{85} Insofar as purchasers under the \textit{Lind} rule are enriched, innocent sellers may have a restitution interest in the earnest money proceeds.\textsuperscript{86} The standard legal measure of damages ignores this actual loss.

Second, ordinary remedial formulas fail to account for the likelihood that parties negotiated liquidated damages clauses to allocate risks of undercompensation. Sellers of real estate decrease their risk of undercompensation by demanding higher earnest money deposits.\textsuperscript{87} In response, purchasers demand price concessions for increasing their

\textsuperscript{82}. \textit{PROPERTY LAW}, supra note 2, at § 10.3.

\textsuperscript{83}. \textit{See} \textit{PROPERTY LAW}, supra note 2, at § 10.3 (loss-of-bargain damages may leave parties undercompensated).

\textsuperscript{84}. Corinthian Corp. v. White & Bollard, 74 Wash. 2d 50, 52, 442 P.2d 950, 952 (1968) (an option contract exchanges, for valuable consideration, the privilege of buying the property within a specified time upon the terms and conditions expressed in the option).

\textsuperscript{85}. By impeding sales of property to third parties, defaulting buyers receive the benefit of their bargains without a \textit{quid pro quo}. "Consider the result achieved by the purchaser in \textit{Lind}. At a time when the prime rate was running between 11 and 11-1/2 percent, the Purchaser was able to tie up a multi-million dollar piece of property for eight months at no cost." Sperry & Snyder, supra note 33, at 5.

\textsuperscript{86}. \textit{Sales of goods} remedies recognize an analogous interest. Under \textit{WASH. REV. CODE} § 62A.2-718(3)(b) (1989), sellers of goods can offset breaching purchasers' claims for recovery of payments to the extent they can establish that such purchasers received any direct or indirect benefit from the contract. Similarly, regardless of actual injury, \textit{WASH. REV. CODE} § 62A.2-718(2)(b) (1989), entitles sellers of goods to retain deposit payments of a minimum of 20\% of the value of the total performance or $500, whichever is smaller.

\textsuperscript{87}. \textit{See} supra note 68 (\textit{Mahoney v. Tingley}).
exposure to liability. Courts permitting a no actual injury defense may undercompensate sellers by ignoring that sellers pay risk premiums.

Finally, the no actual injury defense ignores sellers' transaction and opportunity costs attributable to buyers' breach. Once any contingencies expire, sellers incur financing costs until the date set for closing. In addition, sellers frequently bear the costs of negotiating and drafting documents, brokers' commissions, surveys, appraisals, and the like. Under loss-of-bargain damages, such costs are deemed necessary to complete performance, and their recovery is disallowed even though sellers might have to tolerate successive breaches before finally completing a sale. To the extent that such transaction costs have no value in later agreements, in rising markets the no actual injury defense denies sellers complete relief.

Moreover, sellers may need sale proceeds to facilitate further transactions. If markets rise, they suffer lost opportunities when defaulting buyers force them to reenter the market later and at higher prices. By failing to compensate these transaction and opportunity costs, the no actual injury defense leads to unfair results in real estate transactions. Courts could produce more equitable outcomes by enforcing remedies that parties fairly and knowingly presumed would compensate them for their harm.

IV. CONCLUSION

Favoring liquidated damages clauses secures the utility of agreed remedies. Allocating business and litigation risks through liquidated damages clauses helps parties ensure adequate relief for broken promises. Contractual freedom to predetermine remedies expedites dispute resolution. Together, these benefits remove economic barriers and create incentives to contract.

In *Lind Building Corp. v. Pacific Bellevue Developments*, the court created a "no actual injury" defense to liquidated damages recovery by holding that a liquidated damages clause is unenforceable if the innocent party would receive no damages under a contract minus market formulation. To apply the defense, courts must assess clauses' validity by the facts at the time of trial, in addition to the circumstances surrounding parties when they formed their agreements.

88. *Property Law*, supra note 2, at § 10.3.
89. Platts v. Arney, 50 Wash. 2d 42, 46–47, 309 P.2d 372, 375 (1957). In a strong market, for example, buyers could pledge several earnest money deposits at once to avoid missing favorable buys. If buyers breach some of their contracts, *Lind* requires sellers who eventually recover the original contract price in later sales to refund prior deposits.
Deviating from the traditional prospective approach threatens the utility of liquidated damages clauses by making their validity unpredictable. Moreover, compensatory principles fail to justify the no actual injury defense. Indeed, to the extent that ordinary remedial measures exclude legitimate contract interests, the defense is founded on a faulty premise and leads to the very inequities it was created to avoid.

To perpetuate Washington’s policy favoring liquidated damages clauses, courts should reject the no actual injury defense. Judging validity as of contract formation amply safeguards against penalties while maximizing the benefits of predetermined remedies. When parties freely and fairly fix damages in advance, rather than rewriting their agreements, courts should permit innocent parties to “keep the change!”

*James Arthur Weisfield*