

# Liquidated Damages & Arbitration/Mediation Clauses

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In many purchase contracts today there are two special clauses that must be initialed individually to be included in the contract. If both the buyer and seller do not initial the clauses they are not part of the contract.

The first is Liquidated Damage. Barron's Law Dictionary defines Liquidated Damages, as "An amount stipulated in the contract which the parties agree is a reasonable estimation of the damages owing to one in the event of a breach by the other".

I have found that many people do not fully understand what the liabilities are of agreeing to this clause. Let's take it in three steps; what is the clause for? When does it go into affect? What are the ramifications of signing this clause?

The clause's purpose is to bind the buyer to the contact, and put the buyer in the position of losing money if he backs out of the deal without good reason.

The clause goes in affect after the buyer have been provided all of the financial information requested in the purchase contact and the buyer has had time to review that information. The contract has a clause that says the buyer usually has 10 or 15 days to review the documents before being asked to sign a document that says you have done your due diligence and are satisfied with what you have reviewed. When that is done the escrow can continue with the steps necessary to close the purchase.

If the purchase contract includes a contingency for creating a new lease or assuming an existing lease the buyer needs to get with the landlord and arrange to be approved, by him, for the new or assumed lease. When that is done and the buyer is approved, in writing, the purchaser(s) will again be asked to sign the document releasing the lease contingency that says the buyer is satisfied with the lease arrangement with the landlord.

This written document releasing the contingencies for the lease and financial information are called "Removal of Contingency Form." Only after this form is signed or a written letter stating that the buyer is removing all contingencies does the Liquidated Damage Clause, in the contract, go into action.

It is important to note that the contingency removals cannot happen automatically. They must be removed in writing. In years passed the contract would say the buyer had 10 days to remove contingencies, and if the buyer didn't notify escrow, in writing, that there was a problem, the contingency was removed automatically and the buyer was assumed to have approved the documents and lease terms. No more, the courts decided that the buyer should not loose his right to object, automatically and now buyers have to sign a written document stating that the contingencies are removed.

If a seller or his agent is not aware of this change, in the law, the buyer may never be asked to remove the contingency and it will remain open during the whole escrow. This means that the buyer can back out of the deal without penalty.

The correct procedure is for the seller's agent, when the review period is reached, to send a notice to the buyer requesting the written removal of the contingencies within a 24 hour period or the seller can cancel the escrow. The buyer then usually signs the "Removal of Contingency Document or writes the letter to escrow. If the buyer doesn't do this, the seller cancels escrow and gives the buyer back his deposit.

Again, signing this Liquidated Damage clause and then releasing the contingencies, activates the clause. If the buyer backs out of this escrow for any reason, except something that is the seller's fault, the buyer will loose 100% of his deposit.

Why would anyone sign this clause? The alternative to not signing this clause may be worse than signing it and losing your deposit. If the buyer backs out of the deal for no good reason the seller can and probably would do the following: First he would refuse to let escrow return the buyers deposit. Without an agreement between both the buyer and seller the escrow cannot do anything. This would result in the money sitting in escrow until the parties sue each or settle out of court. No one knows who will win in a lawsuit and how an out of court settlement will go?

Second, if they go into court the seller(s) will argue to the Judge that the buyer backing out of the deal damaged him. The seller would present arguments about of monetary damages that were suffered and ask the Judge for all the deposit plus more, to cover the damage. This gives the Judge total power to decide what the buyer will be charged for backing out of the purchase. Sometimes the Judge feels that the seller should get nothing. One example would be the case where the seller found a new buyer and resold the property/business to another buyer for an amount equal or greater. The reverse could also be true.

If the second buyer paid a lower price, the Judge may then decide to charge the first buyer for the difference in sale prices-the loss between the two prices. I have found from experience that some Judges do not make intelligent decisions with regard to these matters. I will not say they are crazy but some can appear that way on business issues.

Conclusion about Liquidated Damages: Going to court is like flipping a coin, or maybe it is more like Russian roulette. One thing is for sure the bad guy always wins, referring to the attorneys.

The second is Arbitration/Mediation. Arbitration and Mediation are both methods of avoiding lawsuits. They do however still involve attorneys and a paid mediator. Lets start with the definitions of the word

Arbitration: "Arbitration is a process where disputing parties present their disagreement to an impartial third party for the purpose of making a determination of the outcome. This third party, called a neutral, (third party), makes a determination based on evidence presented during the arbitration process. Evidence is given the appropriate "weight it deserves" as most rules of evidence are relaxed in the arbitration process." – Cohen & Associates, Inc.

Mediation: "Mediation is a consensual dispute resolution process where a neutral third party assists the disputing parties in coming to a mutually agreeable solution. The mediator has no power to impose a decision as he would if he were an arbitrator or judge." – Cohen & Associates, Inc.

Mediation is preferable to a lawsuit or arbitration. The mediator tries to help the parties to reach a settlement and no one is subject to a decision being forced upon them. Of course, no one likes to be forced to do anything against his or her will. But if the parties do not come to an agreement, the parties leave and fight it out in the court system.

If you agree to arbitration, the arbitrator is like a judge. His decision is final, with no right of appeal. The advantage to arbitration is that it is all over in less than 3 months instead of 1 to 2 years of stress and paying your attorney to go to court hearings.

The advantage of speed is a very important issue. The longer things drag-on the more money it costs, and the more upsets there are which affects your work, social life, home life and health.

Here are your choices. As a buyer you get to make your choices and live with it. The seller may demand that you agree to arbitration and of course you can refuse, possibly killing the deal.

So, there you have it, the ins and outs of liquidated damages and the low down on arbitration/mediation. Whatever you decide to do about these two clauses in the purchase contract, I hope you have found this article useful. Willard Michlin is an Investor, Business Broker, California Real Estate Broker, Accountant, Financial Distress Consultant, Well known Public speaker and Administrative/Business Consultant. He can be contacted at his Ventura, California office by calling 805-529-9854 or by e-mail at [kismetrei@earthlink.net](mailto:kismetrei@earthlink.net). See other article by Willard at <http://www.kismetbusinessbrokers.com>