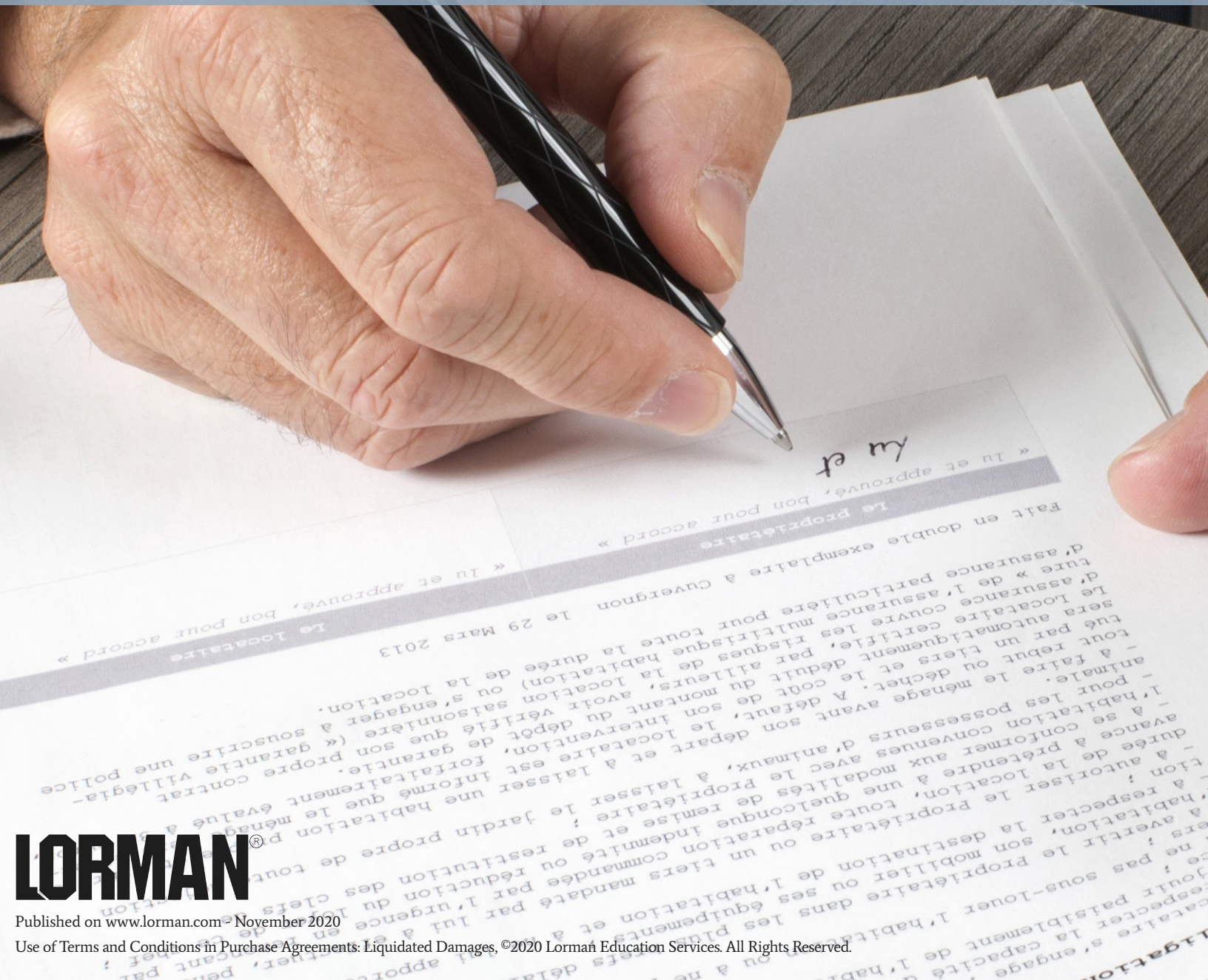
Use of Terms and Conditions in Purchase Agreements: *Liquidated Damages*

Prepared by:
Timothy Murray
Murray, Hogue & Lannis



LORMAN®

Published on www.lorman.com - November 2020

LORMAN®

Lorman Education Services is a leading provider of online professional learning, serving individuals and teams seeking training and CE credits. Whether you're looking for professional continuing education or an enterprise-wide learning and development solution, you will find what you need in Lorman's growing library of resources.

Lorman helps professionals meet their needs with more than 100 live training sessions each month and a growing collection of over 13,000 ondemand courses and resources developed by noted industry experts and professionals.

Learn more about Lorman's individual programs, economical All-Access Pass, and Enterprise Packages:

www.lorman.com

LIQUIDATED DAMAGES

The benefits of a liquidated damages provision designed to spell out the damages available in the event of a breach—promoting certainty and eliminating the litigation expense of proving damages—are obvious. But these provisions often are not enforced.

To be enforceable: (1) the loss or harm from a breach of the contract must be uncertain or difficult to prove with certainty, and (2) the liquidated damages must be reasonable in light of the anticipated or actual damages caused by the breach.[1] The second prong of this test is a modification of the traditional common law test, which required liquidated damages to be a reasonable forecast of damages *at the time of contract formation*.[2] In contrast, the modern test allows a second look—even if liquidated damages were an unreasonable forecast at the time of contract formation, the provision will be enforced if it turns out to be a reasonable approximation of the actual damages incurred.[3]

Former Judge Richard Posner called the law of liquidated damages "mysterious" and voiced what a lot of attorneys have pondered: "[I]t is difficult to see why the law should take an interest in whether the estimate of harm underlying the liquidation of damages is reasonable. Courts don't review the other provisions of contracts for reasonableness; why this one?"[4] Another jurist wrote this:

> As children, we learn that the rules of the playground dictate that if someone makes a promise, no matter how solemnly, it is unenforceable if the person making the promise had his fingers crossed behind his back. As we

---

[1] See, e.g., Restatement (Second) of Contracts § 356 (Am. Law Inst. 1981) and U.C.C. § 2-718(1).
[2] John E. Murray, *Murray on Contracts* § 126 (5th ed. 2011).
[3] Make sure to check the law in the governing jurisdiction to see if it follows the modern or traditional tests. Note that even if a jurisdiction has adopted the modern test, it is not uncommon for courts to still cite the traditional test—the court might have to be educated on this point.
[4] XCO Int'l, Inc. v. Pac. Sci. Co., 369 F.3d 998, 1001 (7th Cir. 2004).

> grow up, we learn instead that many promises are moral and legal obligations, with consequences properly attached to breaking them. Still, some grown-ups prefer the playground rules.[5]

Clients often want to impose liquidated damages not to provide a reasonable estimate of possible damages but to motivate the other party to perform. There is nothing wrong with using liquidated damages to motivate the other party to perform, but the amount of liquidated damages can't be plucked out of the air—it must bear a reasonable nexus to the actual harm, anticipated or actual.

The Two Prong Test

1. **Uncertainty:** Actual damages arising from a breach of the contract must be uncertain or difficult to prove with certainty. "[N]ot many cases have appeared to turn primarily" on this prong, but "a liquidated damages clause is most useful to the parties and most likely to be upheld in cases where actual damages are most difficult to prove, as in the case of a covenant not to compete ancillary to the sale of a business, for breach of a franchise agreement . . . ."[6] The more uncertain the damages, the greater the free reign the parties have in arriving at liquidated damages.[7] The more *certain* the actual damages, the less freedom drafters have in setting liquidated damages.

In *Ramada Worldwide v. Key Hotel of Brewton*,[8] Ramada's franchise agreement with Key Hotel required the latter to operate a 90-room Ramada hotel for fifteen years. The contract stated that if Key Hotel breached, it would owe Ramada $1,000 per guest room. Less than four years into the contract term, Ramada terminated the franchise due to Key Hotel's breaches. In the ensuing litigation, the court held that $90,000 in

---

[5] Dobson Bay Club II DD, LLC v. La Sonrisa de Siena, LLC, 242 Ariz. 108, 116-117, 393 P.3d 449, 457-458 (2017)(Bolick, J., dissent).
[6] 11-58 Corbin on Contracts § 58.7 (2017).
[7] Metlife Capital Fin. Corp. v. Wash. Ave. Assocs. L.P., 159 N.J. 484, 494, 732 A.2d 493, 498 (1999). "If the damages caused by a breach are difficult to estimate, either at the time of contracting or at the time of breach, the likelihood that a liquidated damages clause will be sustained is greatly increased." 11-58 Corbin on Contracts § 58.7 (2017).
[8] 2016 U.S. Dist. LEXIS 95790 (D. N.J. 2016).

liquidated damages ($1,000 per room) was not excessive—it "replace[d] the income that Ramada would have received if [not] for the premature termination of the License Agreement." Such damages were not capable of precise forecast, and an estimate was appropriate.

Restrictive covenants accompanying the sale of a business are appropriate transactions for liquidated damages. In the event the seller breaches by taking customers from the buyer, damages cannot be known with precisions but are likely to far exceed the dollar amount of immediate business lost—this is because the customers wrongly taken might have remained customers of the buyer far into the future.[9]

Confidentiality and non-disclosure agreements are also apt candidates for liquidated damages. A valid liquidated damages clause does not in itself bar injunctive relief in most jurisdictions.[10]

2. <u>Reasonable in light of anticipated or actual damages</u>: The second prong of the test is more controversial. It is the reason courts generally give for refusing to enforce liquidated damages.

The purpose of contract law is to *compensate* aggrieved parties, not to *punish* breaching parties (the word "compensation" routinely pops up in judicial decisions explaining liquidated damages).

Here are some common problems:

A number is plucked out of the air.

In *Dobson Bay Club II DD, LLC v. La Sonrisa de Siena, LLC,*[11] to repay a $28.6 million loan to purchase commercial properties, Dobson Bay agreed to make interest-only payments until the loan maturity date, at which time the entire principal would be due in a balloon payment. For any delay in payment,

---

[9] Ferraro v. M & M Ins. Group, 2017 Pa. Super. Unpub. LEXIS 4551 (2017).
[10] 12-65 Corbin on Contracts § 65.33 (2017).
[11] 393 P.3d 449 (Ariz. Apr. 25, 2017).

Dobson Bay agreed to pay interest, default interest, collection costs including reasonable attorney fees--*and* a 5% late fee assessed on the payment amount. Dobson Bay missed the deadline to make the balloon payment. The lender sued, and Dobson Bay proceeded to pay off everything—except the 5% late fee, amounting to nearly $1.4 million. The court held that the 5% late fee was an unenforceable penalty because it did not reasonably forecast the lender's anticipated damages likely to result from an untimely balloon payment. The handling and processing costs, and the loss of use of that money, were addressed in *other* fees assessed against Dobson Bay.

One size does not fit all.

When drafters assign as liquidated damages a single dollar amount for all possible breaches—even when they vary in severity—the clause might be held unenforceable. In the *Dobson Bay* case, discussed above, the court found it important that the 5% late fee was payable regardless of how late a payment would be. "Five percent of the loan principal is a significant sum of money, which did not likely reflect losses from a short delay in payment. Because the fee did not account for the length of time [the lender] would be deprived of the balloon payment, the fee could not reasonably predict the Bank's loss."[12]

A penalty can't be gussied up as liquidated damages.

Drafters often state in the contract that the agreed damages are "liquidated and not a penalty." Courts generally don't credit these characterizations,[13] though some courts have stated that they are entitled to *some* weight.[14] Conclusory labels aren't especially helpful—more helpful is to succinctly state the specific rationale for the dollar amount chosen.

Disguised penalties.

Sometimes parties agree that one of them will pay the other a sum of money, and if it isn't paid by a certain date, the

---

[12] Dobson Bay, 393 P.3d at 453.
[13] Wilmington Housing Authority v. Pan Builders, Inc., 665 F. Supp. 351 (D. Del. 1987).
[14] Walter Motor Truck Co. v. State, 292 N.W.2d 321 (S.D. 1980).

party in breach must pay a significant additional sum. The parties often characterize this arrangement as a "discount" for early payment, but courts generally see through it and call it what it is—a disguised penalty.

In *Leaman v. Wolfe*,[15] Leaman sued Wolfe, and the two entered into a settlement agreement that required Wolfe to execute a judgment note providing for a series of 31 installment payments totaling $475,000--plus an additional $100,000 to be "waived . . . and not . . . due and owing . . . [u]pon Wolfe's timely payment of the . . . [31] installments." Wolfe twice failed to make installment payments by the due dates. Leaman filed a judgment note for $100,000, plus the unpaid balance, attorneys' fees, and costs. The court held that the $100,000 charge was an unenforceable penalty: "[A] $100,000 charge in the event of an untimely payment is extravagant and disproportionate to any reasonable estimate of damages accrued using the applicable interest rate."[16]

Per diem liquidated damages

Contracts often state that time is of the essence for completion of construction projects and impose per diem liquidated damages for delay in completing performance. "Since the injury caused by such delay is nearly always difficult to determine, the courts strongly incline to accept the estimate as reasonable and to enforce such provision."[17] Liquidated damages are often used in imposing damages for government infrastructure contracts.[18] In those cases, "the delay in use of, for example, a highway, by the public is difficult to project and measure."[19] Damages arising from a contractor's delay are generally enforced given this uncertainty, especially where "the amounts of liquidated damages [are] graduated according to the size of the project"[20] and the liquidated damages bear a reasonable relation to damages reasonably anticipated.

---

[15] 629 Fed. Appx. 280 (3d Cir. 2015).
[16] Id. at 283.
[17] 11-58 Corbin on Contracts § 58.21 (2017).
[18] Boone Coleman Constr., Inc. v. Vill. of Piketon, 145 Ohio St. 3d 450, 50 N.E.3d 502 (Ohio 2016); United States ex rel. Ash Equip. Co. v. Morris, Inc., 2017 U.S. Dist. LEXIS 126509 (D. S.D. 2017).
[19] United States ex rel. Ash Equip. Co., 2017 U.S. Dist. LEXIS at *43 (D. S.D. 2017).
[20] Id.

These sorts of clauses are so common, there is a temptation to think they are automatically enforced. Yet, in many cases, per diem liquidated damages are held to be penalties because the evidence shows that the actual damages were greatly disproportionate to the liquidated damages.[21] Under the "extreme case doctrine," per diem liquidated damages are not enforced because the evidence shows that the delay caused no loss whatsoever. An example: where a "race track's completion was delayed by 10 days, but the permit for opening the race track was delayed for one month; thus, the delay in construction did not delay the race track's opening and caused no loss."[22]

DRAFTING TIP:

In setting liquidated damages, don't ask for too much: if the liquidated damages provision is deemed to be a penalty, a court might hold that it is unenforceable. The drafter would be free to try to prove damages—but if the damages are too uncertain, the drafter would be out of luck.

Parties to a contract need to anticipate how the contract might be breached and what damages would reasonably result from any such breaches—then they can assign a dollar figure that mirrors that forecast as their liquidated damages. The problem is, too many drafters try to use liquidated damages solely for a purpose the law doesn't recognize: to motivate the other party to perform.

---

[21] Brinich v. Jencka, 2000 PA Super 209, 757 A.2d 388 (2000). See also 11-58 Corbin on Contracts § 58.21 (2017).

[22] Int'l Marine, L.L.C. v. FDT, L.L.C., 619 Fed. Appx. 342, 351, n. 9 (5th Cir. 2015), citing Restatement (Second) of Contracts § 356 cmt. b, ill. 4 (Am. Law Inst. 1981).