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4 Liquidated Damage Provision Drafting Mistakes To Avoid

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Even if you are not a litigator, thinking like one when drafting contracts can help you avoid land mines that you otherwise might not know are there. One area where this is especially true is when dealing with liquidated damages. While a liquidated damages provision can be an effective way to fix the amount of money one party will pay to the other if a breach occurs, drafting an enforceable and effective liquidated clause is not as simple as stating, if X breached, then Y gets $1 million. Four of the most common mistakes center around:

1. Failing to ensure the liquidated amount is reasonable (i.e., overestimating the damages).
2. Not considering choice of law.
3. Failing to include acknowledgements by the opposing party.
4. Failing to allow for a choice of recovery.

Thinking like a litigator (and learning from the mistakes of others that litigation exposed) may help you avoid these traps for the unwary.

Is the Liquidated Amount Reasonable?

The mistake — The obvious tendency when drafting a liquidated damages provision is to include a liquidated amount that is high. If the amount is too high and not a reasonable estimate of the actual damages, you run the risk of a court deeming the clause to be a “penalty” and striking the provision.

Avoiding the mistake — In many jurisdictions, there are two basic requirements for a liquidated damages provision to be enforceable:

1. At the time of drafting, it would be difficult to determine the damages that would be caused if the contemplated breach were to occur; and
2. At the time of drafting, the liquidated amount is a reasonable estimate of the actual damages that your client would suffer if breach did in fact occur.

While a bit oxymoronic, keeping this in mind is critical, as many courts will not reform or reduce a liquidated damages clause in a contract in order to make the provision enforceable. Thus, if the court determines that the liquidated amount is greater than what could have reasonably been expected at the time the contract was drafted, it probably will strike the provision in its entirety, and require the plaintiff to prove its actual damages. Further, assuming that you used a liquidated damages clause because proving damages would be difficult or impossible, having your liquidated damages clause stricken could be fatal to any recovery.

Consider Governing Law Wisely

The mistake — The rules that apply to liquidated damages provisions are governed by state law, and not all states treat them the same way. For example, the following are three different standards applied by courts in various states to determine whether the liquidated amount is reasonable:

- Consideration of only the parties' knowledge at the time the contract was executed. See, e.g. Kelly v. Marx, 428 Mass. 877, 705 N.E.2d 1114 (1999).
- Consideration of both the parties' knowledge at the time the contract was executed and the relation of the liquidated amount to the actual damages caused by the breach. See e.g., Lake Ridge Acad. v. Carney, 66 Ohio St. 3d 376, 613 N.E.2d 183 (1993).
- Consideration of either the parties' knowledge at the time the contract was executed or the relation of the liquidated amount to the actual damages caused by the breach. See e.g. Wasserman's v. Twp. of Middletown, 137 N.J. 238, 645 A.2d 100 (1994).

Avoiding the mistake – While you may or may not have the ability to choose governing law that will make it easier for you to enforce a liquidated damages provision and/or you may have important reasons for wanting a certain state law to govern the contract because of its impact on another contractual provision, it is important at least to consider how the governing law will or might impact your liquidated damages provision. The last thing you want to do after an opposing party breaches the contract is explain to your client that the liquidated damages provision that she wanted so much actually is not enforceable at all.

Include Language that Improves Your Chance of Success

The mistake – As discussed above, many courts will not reform or reduce a liquidated damages clause if the estimate is unreasonably high; rather, the court will strike the provision in its entirety and require the aggrieved party to prove its damages, which may be extremely difficult, if not impossible. As such, simply setting out a liquidated amount may be fraught with peril.

Avoiding the mistake – Adding language to your agreement can bolster your position if you have to argue that the liquidated amount is reasonable. For instance, include in the contract that the parties acknowledge and agree that if a breach were to occur, it would be difficult to determine actual damages. The contract also should state that based on the parties' knowledge at the time of contracting, the parties agree that [$X] is a reasonable estimate of the damages that would accrue if a breach occurred in the future. Further still, if you have a logical explanation as to why the liquidated amount is reasonable, include the details. Finally, and while certainly not binding on the court, you also should formalistically recite that the parties agree that the liquidated amount (i) is fair, reasonable and would not amount to a penalty; and (ii) is not intended to act, nor would it act, as a penalty under the circumstances.

Account for Plaintiff's Choice of Recovery

The mistake – Some jurisdictions permit plaintiffs in a breach of contract action to choose specific performance as a remedy for a breach even when a liquidated damages clause exists (but, of course, a plaintiff cannot choose both liquidated damages and specific performance.) For example, in Massachusetts, courts have consistently held that "the right to specific performance either affirmatively or by way of injunction is not lost because the contract contains a provision for the payment of a penalty or liquidated damages in the event of a breach." K.G.M. Custom Homes Inc. v. Prosky, 468 Mass. 247, 256-57, 10 N.E.3d 117, 125 (2014), overruled on other grounds, K.G.M. Custom Homes Inc. v. Prosky, 89 Mass. App. Ct. 1130, 54 N.E.3d 606 (2016) (quoting Rigs v. Sokol, 318 Mass. 337, 342-343 (1945)). Practitioners sometimes lose sight of this, which can lead to forfeiting the specific performance option.

Avoiding the mistake – A starting point to gather information on this issue is finding out whether the state law governing your agreement treats the Restatement (Second) Contracts, § 361 favorably, as that Section provides: "[s]pecific performance or an injunction may be granted to enforce a duty even though there is a provision for liquidated damages for breach of that duty." If it does, the next inquiry would be to determine whether the governing law considers the intention of the parties in including the liquidated damages provision. For example, in Massachusetts, courts will analyze whether the liquidated damages provision was intended to be an alternate to performance, or whether the parties intended it to be security for the performance. In Northeastern University v. Brown (17 Mass. L. Rep. 443 (2004) (quoting Rigs v. Sokol, 318 Mass. 337, 343 (1945), the court explained:

> [There is an] assumption that the parties ordinarily contemplate that the contract be performed and that the provision for a penalty or liquidated damages in the event of a breach is intended as security for performance and not as a price for the privilege of nonperformance. A contract, of course, may provide for the payment of a fixed sum as an alternative to performance. Whether such a provision is merely security for the performance of the contract or an alternative to its performance depends upon the intention of the parties to be deduced from the whole instrument and the circumstances.

A few examples of fact patterns where courts have held that the liquidated damages provisions were intended to be security of performance, and not an alternative to performance, thus permitting the plaintiff to choose between the remedies of specific performance and liquidated damages, include the following:

- In Rigs v. Sokol, 318 Mass. 337, 343 (1945), the court held that, in a contract for the sale of the fixtures, equipment and good will of a restaurant business, and for the giving of a lease by the seller to the purchaser of the premises on which the business was conducted, a provision providing for $500 if either party refused to perform was intended to be security for the performance of the contract and not a fixed price to be paid for the privilege of nonperformance.
- In Novelty Bias Binding Co. v. Shevrin, 342 Mass. 714, 718-19, 175 N.E.2d 374, 377 (1961), the court held that a $30,000 note could not be considered a substitute for performance or as a bar to the plaintiffs' right to specific performance, where the note was described as collateral to guarantee the employee's compliance with the terms of a restrictive covenant.
- In Northeastern University v. Brown (17 Mass. L. Rep. 443 (2004) (quoting Rigs v. Sokol, 318 Mass. 337, 343 (1945), the court held that a liquidated damages clause in the event that the university's football coach left his job before his contract was complete permitted the university

to collect the liquidated amount or, in the alternative, elect the remedy of specific performance or an injunction.

Of course, the best option is to expressly state in the contract that all parties agree that the nonbreaching party has the option of seeking liquidated damages or injunctive relief.

Conclusion

While many transactional attorneys have been using the same liquidated damages provision for years without incident, if it hasn't been tested in court, that tried and true provision may very well be vulnerable in a variety of ways. So the next time you are considering including a liquidated damages provision in an agreement, approach it with a fresh attitude and with the foregoing issues in mind.

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