

CONTRACTS

A Context and Practice Casebook

Michael Hunter Schwartz
Denise Riebe

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Chapter 8

Agreed Damages

Exercise 8-1: Chapter Problem

You are a new associate in a law firm. The senior partner in your law firm has just dropped a project in your lap. She told you that the firm represents a small motorcycle manufacturing company and she asked you to draft what she calls a “bullet-proof liquidated damages clause.”

By using the term “bullet-proof liquidated damages clause,” the partner means that she wants you to draft a clause that is so unquestionably enforceable that no rational lawyer would challenge the clause. The partner told you that the assignment of drafting the entire contract has been divided up among several associates. Your only task is to draft the liquidated damages clause.

The clause will be used as part of a contract between your client and a construction company that is building the client a new manufacturing factory. The partner provided you with the following additional information about the deal:

- The contract will have a construction completion date of July 1, 2009.
- The client wants the project finished on time and, therefore, wants the clause to address what will happen if the construction company does not complete construction on time.
- The client estimates that the new plant will save the client \$4,000,000 per year over the fifteen-year useful life of the plant. These savings stem from a number of factors; specifically, the new factory will allow the client to reduce its number of employees because it will automate more of the client’s manufacturing processes, and the new machinery will require less power to operate than the machinery in the existing factory.
- The client also believes that the new factory will allow the client to produce better, more reliable motorcycles — thereby increasing the client’s profits, although the client has stated that it cannot determine how much its profits will increase.

Introduction to Agreed Damages

For only the second time in your study of contracts, you are about to learn about a particular type of contract clause frequently included in contracts: “agreed” or “liquidated” damages clauses. Lawyers use these two terms interchangeably and so will we in this chapter.

United States v. Swanson, 618 F. Supp. 1231, 1235–36 (E.D. Mich. 1985). . . . Thus, the scholarship contract is a two-way street. In exchange for the funds to further their medical education, students are expected to serve their fellow citizens through the NHSC upon completion of their studies.

The court finds that it is virtually impossible to determine the amount of damages to the government by the defendant's breach. "A physician or health care professional is not a 'fungible handyman.'" *Swanson*, 618 F. Supp. at 1243. That is, one cannot speculate in the abstract as to the value of a particular physician's services. A variety of factors, which could not be known at the time of contract formation, including ability, skills, specialties, levels of training and education, placement, etc., are all inherent in determining the value of a physician's practice; nor can it be known with what dedication a health care provider will apply herself.

Therefore, it is clear that the liquidated damages provision of the scholarship contract has a direct relation to actual damages, as it is an attempt to fairly and reasonably set just compensation in the event of a breach by the scholarship recipient. In *Swanson*, facing the same issue, the district court, per Freeman, Senior District Judge, held:

For the above reasons, this Court holds that the liquidated damage provision does not operate as a penalty and is valid and enforceable in a court of law. In addition, to the extent that the Defendant raises the argument that the damage provision and the contract in question are unconscionable, this Court rejects this assertion in light of the previous conclusion.

Swanson, 618 F. Supp. at 1244. To this court, the holding in *Swanson* was clearly appropriate.

While the court is not without sympathy for the defendant, it is bound to follow the laws of the Congress. Therefore, this court holds that the liquidated damages provision contained in the scholarship application does not operate as a penalty and is completely valid and enforceable. Defendant is bound by the terms of the scholarship contract and must abide by them. Defendant admits that she is in breach of her scholarship contract, and this court so holds. There being no genuine issue of material fact as to the validity of the liquidated damages provision of the agreement, the Government is entitled to judgment as a matter of law. Therefore, the Government's motion for summary judgment is granted. The Government is directed to submit a judgment reflecting the opinion of the court and calculating damages as of the date of this opinion. It is so ordered.

Chapter Problem Revisited

Exercise 8-1 at the beginning of this chapter asked you to draft a liquidated damages clause. To do so, use what you have learned about liquidated damages clauses in this chapter and the drafting guidance below:



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1. Implement your client's goals: Your client wants to encourage the contractor to complete the job on time; to maximize its recovery if the contractor delays completion; to have a court, if necessary, affirm the enforceability of the clause; and to have a clause that is so clearly enforceable that the contractor would not even litigate the issue.
2. Be explicit about the effect you want the contract term to have.
3. Use clear and simple language. Ineffective lawyers draft obscure contract terms, which often become the subjects of litigation.
4. Carefully edit your work product. Your work product will reflect on your level of professionalism and effectiveness as a lawyer. Ensure that any work product you produce is polished.

In addition, it may be helpful to review some sample liquidated damages clauses in formbooks and to read some articles about liquidated damages. Both are available in your law school library. For example, one article that is useful for understanding drafting principles is *How to Draft and Enforce a Liquidated Damages Clause* by Henry Luepke.⁶ While we encourage you to read the entire article, below we are providing some key points and excerpts from the article:⁷

1. Express your client's intent. As Luepke states, "If the parties intended the clause to serve as compensation for the damages likely to result from a breach, the court will uphold the clause and enforce it as written. If, on the other hand, the clause was intended to serve as punishment for a breach, the court will refuse to enforce it." Thus, "when drafting a liquidated damages clause, counsel should use language demonstrating that, at the time of contracting, the parties intended the liquidated amount to fully compensate, but not punish, for a breach of the contract." Luepke specifically advises:

The simplest way to demonstrate that the intent of a provision for liquidated damages is compensatory rather than punitive is to explicitly state this intent in the clause itself. Specifically, the clause should provide that the liquidated amount to which the parties have agreed is intended as compensation and is not intended as punishment.

2. Label the clause as a "liquidated" or "agreed" damages clause. As Luepke notes, "It is true that labeling a liquidated damages provision as either one for compensation or as one for a penalty is not conclusive on the issue of whether it will or will not be enforced. Nevertheless, courts are generally constrained to give effect to the parties' intention as expressed by the plain terms of the contract."
3. Be cognizant of the enforceability test your clause will have to pass. As Luepke states:

[A] court will have to answer two threshold questions, *i.e.*, 1) is the liquidated amount a reasonable forecast of just compensation in the event of a breach?; and 2) is the liquidated amount for a harm that was incapable or very difficult of accurate estimation at the time the contract was made?

6. Henry F. Luepke III, *How to Draft and Enforce a Liquidated Damages Clause*, 61(6) J. OF THE MO. BAR (Nov.-Dec. 2005), available at <http://www.mobar.org/3e32eff7-3358-410b-bf01-a04541224948.aspx> (last visited May 7, 2008). Note that the full version of the original article includes endnotes with supporting citations.

7. All quotes in the list of points are from Luepke's article; citations are omitted.

Because the intent of the parties is to be ascertained from the plain language of the contract, the answers to these questions should be made explicit in the terms of the liquidated damages clause. For example, the liquidated damages clause might state explicitly and explain why the damages to be suffered in the event of breach are very difficult of accurate estimation and, for this reason, the parties have agreed that the amount fixed by the clause is a reasonable forecast of just compensation in the event of breach.

4. Specify the type of breach for which the liquidated amount is intended as compensation. Luepke explains:

All breaches are not alike, and a liquidated damages clause should not treat them as if they were. . . . Where a liquidated damages clause applies equally to multiple types of breaches, regardless of the significance or magnitude of the breach, the scope of the clause is overly broad, and a court will likely find that the intent of the provision is punitive, regardless of statements indicating a contrary intent.

The terms of the clause, therefore, should specify the types of breaches to which it applies and should clearly show that it is intended to provide compensation only for the type of breach that would result in the damages that are difficult or impossible to calculate.

5. Specify the type of harm for which the liquidated amount is intended as compensation. As Luepke notes, “the anticipated harm for which a liquidated damages clause is intended to compensate may not always be obvious to a court.” Accordingly, parties to a “liquidated damages clause . . . would do well to specify the types of difficult-to-quantify harm for which the clause is intended to provide compensation.” For example, “where breach of a contract may result in a loss of profits . . . the clause should state that the liquidated amount is intended to compensate for the difficult-to-calculate loss of anticipated profits that the parties agree would result from the type of breach in question.”
6. Provide a formula for calculating the liquidated amount. A formula is preferable to a lump sum because the amount of damages will vary with the type and duration of breach. For example, a clause could state that a certain amount is to be added to a base liquidated amount for each day contract performance is delayed. Or, where the anticipated harm is lost profits, the liquidated sum could be set as a percentage of the gross amount yet to be paid under the contract. The advantage in using a formula is that it ensures “that the liquidated amount will be adjusted according to the relative degree or magnitude of the breach.” Accordingly, a court is more likely to find that “the amount to be recovered as liquidated damages is intended to bear some relationship to a reasonable forecast of the probably damages and, therefore, is intended to compensate, not punish, for a breach. On this basis, a liquidated damages clause will likely be enforced.”

Professional Development Reflection Questions

1. In drafting the liquidated damages clause assigned as the Chapter Problem, you may believe that there are conflicts between two of the client’s goals. Under such circumstances, what should you do?