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, 2015.
- 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

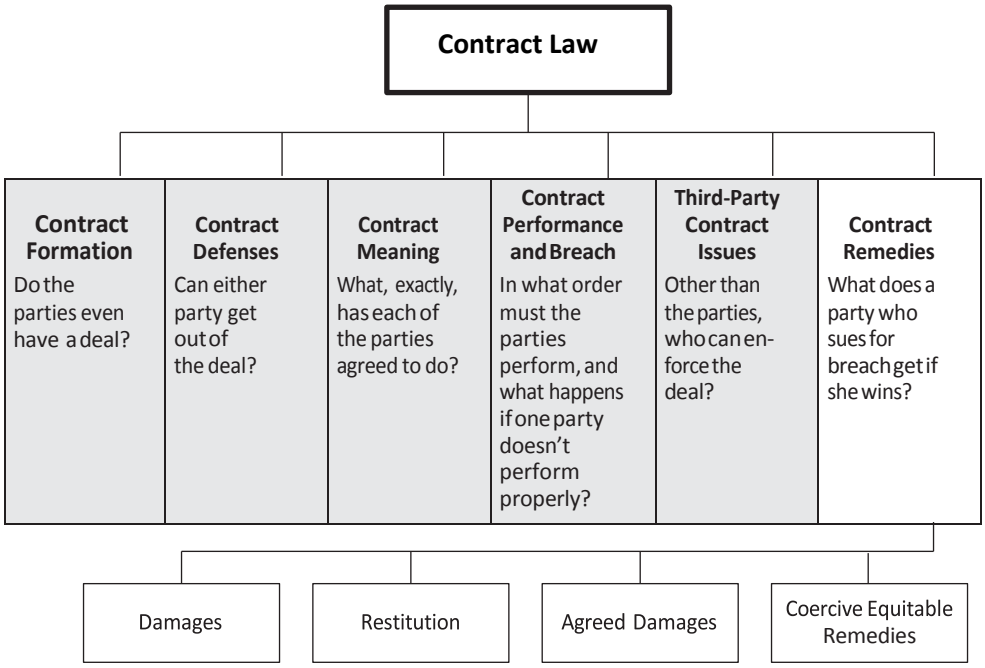
You are about to learn about a particular type of contract clause frequently included in contracts: "**agreed**" or "**liquidated**" damages clauses. Lawyers use these two terms interchangeably and so will we in this chapter.

Diagram 8-1 depicts where this topic fits within the bigger picture of contract law. As you

[†]**Materials excerpted with permission from MICHAEL HUNTER SCHWARTZ & ADRIAN WALTERS, CONTRACTS: A CONTEXT AND PRACTICE CASEBOOK (2d ed. 2015).**

will see, "Agreed Damages" is the third box under the sixth major contract subject, "Contract Remedies."

Diagram 8-1: Contract Law Graphic Organizer



You need to learn about liquidated damage clauses because they are a common type of clause that lawyers draft and use. There are also many other types of commonly used contract clauses. For example, earlier in this text you were introduced to covenants not to compete and damages waiver clauses. To give you more insight into commonly used clauses, Table 8-1 on the next page provides a non-exhaustive list of common contract terms and a summary explanation of each type of clause. As you work your way through your study of contract law, look for all of these clauses and make sure you understand the effect of each.

Introduction to the Validity of Liquidated Damages Clauses

Courts use a set of specialized rules to determine the validity of liquidated damages clauses, although courts vary greatly in how they frame their tests. Liquidated damages clauses are generally enforceable, but courts strike down such clauses if they are found to be a "penalty." "Penalty" is just a label attached by a court when it concludes that a clause is unenforceable. The "penalty" label does not provide a rule.

Courts generally use a two-part test to determine if a liquidated damages clause is valid (not a "penalty"):

Table 8-1: Common Contract Clauses

Name of Clause	Goal of Clause
Covenant not to compete	Communicates that an employee or a seller of a business cannot compete (for a specified period of time and within a specified locale) with the employer or buyer
Liquidated damages	States an amount a party should be awarded by a court if the other party breaches the contract
Merger	Communicates that the written document contains all of the terms to which the parties have agreed and that prior agreements that are not reflected in the written document are not part of the parties' contract.
No oral modification	Indicates the parties only can modify the contract in writing.
Force majeure	Lists circumstances, usually natural disasters and wars, under which a party can avoid having to perform the contract without penalty.
Time is of the essence	Uses the words "time is of the essence" to communicate an expectation about timely performance of the parties' contract promises.
Choice of law	States the body of law that will govern any dispute between the parties. May also limit the state or city in which either party may file suit. (Lawyers may refer to this latter provision as a "jurisdiction clause.")
Arbitration	States that disputes under the contract will not be decided by a court but, rather, by an arbitrator. Usually includes a specified process for the arbitration (*i.e.,* what rules will be followed and how the arbitrator will be selected).
Indemnification	Communicates that, if one party is sued for a matter relating to the contract, the other party will pay for the costs of defending the suit and will pay any award of damages ordered by the court
No assignments	States that the rights conferred under the contract (and, in some instances, the duties imposed under the contract) cannot be transferred to someone else.
Savings	Indicates the parties have agreed that, if a court invalidates a particular term of the parties' contract, the rest of the contract will remain enforceable.

1. Were the damages difficult to ascertain when the contract was made; and
2. Is the amount stated as liquidated damages reasonable in light of the actual and/or anticipated damages?

In the second prong of the test, the terms "and/or" reflect the fact that courts are split in their articulations of the rule. Also note that the two prongs tend to have an inverse relationship; the more difficult damages are to ascertain, the more leeway courts give parties' efforts to estimate damages (and, conversely, the easier damages are to ascertain, the less leeway courts give parties' efforts to estimate damages). The cases and materials below illustrate the application of these principles.

Overview of Chapter 8

In this chapter, you will learn the tests used to evaluate liquidated damages clauses and how courts apply those tests. You will also learn how to draft a valid and enforceable liquidated damages clause.

Evaluating the Enforceability of an Agreed Damages Clause

Leeber v. Deltona Corp.

546 A.2d 452 (1988)

[. . . Text of case and accompanying reinforcement questions omitted for AALS New Law Teachers' Conference.

Summary: Contract between Florida condo developer and condo buyer. Agreed price for purchase of the unit was $150,200 with 15% down-payment ($22,530), to be retained as liquidated damages if buyers breach. Upon building completion two years later buyers do breach, and developer resells unit for $167,500. Since developer benefitted from breach buyers sue to recover their deposit. Court finds liquidated damages clause enforceable, concluding that Florida law general favors liquid damages clauses where damages not ascertainable at the time the contract was made (as was the case here), the 15% figure was reasonable and not a penalty, and was not unconscionable.]

United States v. Hayes

633 F. Supp. 1183 (1986)

[. . . Text of case and accompanying reinforcement questions omitted for AALS New Law Teachers' Conference.

Summary: Defendant physician entered a contract as a medical student to accept $29,000 in tuition assistance in exchange for working for two years after graduation in a government program designed to provide medical services to underserved locales. Standardized for contract provided for treble damages of $90,000 in event of breach. Court finds damages clause enforceable because calculating the damages to the government would be "virtually impossible," thus the treble damages clause had a direct relationship to the actual damages as a fair and reasonable attempt to set damages in advance.]

[Material omitted for AALS New Law Teachers' Conference]

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:

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. While we encourage you to read the entire article, below we are providing some key points and excerpts from the article:

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?

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."

Class 2

Working Group Problem

Reading effectiveness quiz: *Leonard v. Pepsico*

1. Does the procedural posture of this particular case affect the outcome or the court's reasoning?

2. What legal issue(s) is the court is deciding?

3. What facts support Leonard's contention that he is owed a Harrier jet? (list all)

   What facts suggest that he is not? (list all)

4. Where in the case does the court state the rule(s) of law to be applied?

   Restate the rule(s) in your own language.

5. Why do the defendants win here, but not in *Lefkowitz* or *Carlill*?

6. What contracts policy concerns support the court's holding in this case?

MIDTERM GRADING SHEET

CONTRACT FORMATION

	POINTS POSSIBLE	POINTS EARNED
	8	
Applicable Law • This is primarily a contract for the services of renovation. Any materials purchased are probably ancillary to the work, so under the predominance test, common law should apply.	**1.5**	
Mutual Assent • Not clear from facts who made offer and who accepted. Original offer seems to be Joe for 35K, but that was clearly rejected. • Both parties act as if they have a deal for the three specified parts of the job at $25K. A deposit was given and accepted. Probably enough to show that both had a present intent to form a contract at the time the deal was struck. **Terms and Type** • Sufficient certainty of terms likely requires price and scope of the work. There aren't a lot of details here, but the basics seem covered enough that lack of certainty will not defeat a determination of mutual assent. • Bilateral or Unilateral? ✓ Contract for services could be unilateral because S wants the work actually done, not just a promise to do it. ✓ But no specific language here suggests offer for unilateral, and default rule is bilateral unless specifies otherwise, so probably bilateral. ✓ Classification matters b/c if unilateral than contract not formed until perfect performance. So under classical rule S could still revoke. But R.2d §45 makes unilateral K irrevocable if performance has begun, which here it has. ✓ Chances are, then, whether deemed bilateral or unilateral Joe will be able to show that he has a contract. **Consideration** • No question of consideration in original deal. Bargained-for exchange of money for work. • Did Joe have a pre-existing duty to repair all of the electricity? Unlikely. The parties' discussions back and forth about this seem pretty clear that he was supposed to fix identified problems but was not obliged under the contract to remove and replace all wiring in affected rooms. • Sarah could claim that there was no consideration for the contract modification of extra money for unplanned electrical work. Hold up game when she's living in a torn up house and needs work done ASAP? • But illusory promise means one party doesn't get anything. Here she'd get all new wiring, which is probably a substantial benefit. And there's at least a suggestion that this is required to bring her home into compliance with building codes.	**5.5** 5=*amazing* 4=strong 3=fine 2=some problems 0-1=lacking analysis average = 3	
If no contract • If by any chance Joe loses on the question of whether there was a binding contract, he would have a decent claim for compensation for his work so far under a promissory estoppel theory, because he justifiably relied on Sarah's promises to pay for work done to her house.	**1**	

DEFENSES & DAMAGES

	POINTS POSSIBLE	POINTS EARNED
	10	

Breach

- Sarah breached by locking Joe out of the job and calling in someone else.
- Did Joe breach by changing the plan for wiring work? Very unlikely. Seemed necessary, and both parties indicated assent.

Defenses

- W/o consideration modification wasn't enforceable, or economic duress for modification.
  - ✓ Both illusory promise and duress are doubtful because added work seems necessary, Sarah got a benefit in exchange, and had an opportunity to bargain. Anyway, these defenses would go to price owed when work completed. Wouldn't give Sarah the right to cancel the job.
- Mistake
  - ✓ Seems like both parties thought they didn't need to entirely replace the wiring, but turned out they did. If mistake, then probably mutual.
  - ✓ Scope and price of job drastically changes with wiring, so likely basic to K, and definitely material to parties' exchange because they talked about this back and forth.
  - ✓ If mistake, could void contract. Arguably that's what the parties did when Joe said another $16K and Sarah said go ahead. If so, though, new K now in force.
- Illegality
  - ✓ Not an issue since Joe was going to correct the illegal wiring. If anything, Sarah's *new* contract may be illegal.

6

6=*amazing*
5=strong
4=fine
3=some difficulties
2=problems
0-1=lacking analysis

average = 3.5

Damages

- Partial payment, so defective performance, not non-performance.
- Joe will probably want BoB of his expected profit on the job. Calculated as "get" ($25K or $37K?) minus "give" of cost of labor and materials to complete the work, expected to be $4K (but was that for original deal or including added electrical work?), less the deposit already paid.
- Joe will also ask for reliance damages of $6K, calculated as $3K in materials and $3K in labor.
- Joe may instead ask for damages as expected profit on the basement job he passed up, but since he wouldn't be able to do both jobs, can't get both this and the BoB for Sarah's job. One or the other.
- Sarah should counterclaim for $4K deposit. Chances are this will get swallowed by what she owes Joe, so just deducted from amt. to be paid.
- Depending on what the market would bear (as evidenced by her deal with new contractor?), Sarah may instead argue that Joe made a bad bargain and damages should be calculated as FMV-K price if less. No specific facts support this, though.

4

4= excellent
3=strong
2=fine
1=problems

average = 2.5

Contracts Section 1C
Franklin, Fall 2015

Midterm

Please respond to the attached question as thoughtfully as you can within the time allotted, **explaining and supporting your reasoning** for all important points. If any parts of the question are not clear, or if you believe there is a mistake or typo in the question, please just state the assumptions you are working with and I will grade your paper with that understanding.

If you handwrite your response, please write on only one side of the page, preferably in ink, and make your answer as legible as possible. You are welcome to skip lines if that will make your response easier to read.

You can make any notes you wish on the test itself or on scrap paper. These will be collected, but your markings will not be read or scored. However, you **may not** write on the Restatement/UCC supplement because they will be checked and reused for future exams.

Sarah's 100-year-old brownstone badly needed some updates. She began talks with Joe, a fully-licensed contractor, about the possibility of undertaking a significant renovation to her home. Initially Joe suggested that Sarah do a few minor cosmetic upgrades to the kitchen and bathrooms but focus primarily on bringing all of the plumbing and electrical equipment up to date. He estimated that he could do all that work for about $35,000. This was too much money for Sarah. And though she understood the importance of Joe's attention to what was going on behind the walls, didn't want to devote too much of her limited budget to things she couldn't see or appreciate.

The two continued their conversations and eventually decided they'd aim for a compromise consisting of:

- a new kitchen island and refaced cabinets;
- replacing the tile and building a new walk-in shower in the main bathroom; and
- repairs to the plumbing and electricity, but not full-scale rebuilding of those systems.

This could be done for Sarah's maximum budget of $25,000. Sarah gave Joe a deposit of $4,000 to get started.

The following week Joe and his crew began the project by removing an agreed-upon wall, taking the fronts off of the kitchen cabinets, and tearing out the bathroom down to the studs. It was at that point that Joe noticed the bathroom wiring consisted of consisted of "knob and tube" fittings that these days are considered genuinely dangerous.

Joe went back and explained to Sarah that there was now no way to do the job as they had previously outlined. Leaving the knob and tube wiring wasn't legal, so in addition to running new lines in the demolished bathroom, he would have to investigate, and probably end up replacing the wiring in every room he was working in. The expected electrical work, and the repairs to the walls that would have to be broken into to complete it, would likely cost $16,000 more than projected.

Sarah was shocked and upset. Faced with a house in shambles and few other options, she tearfully told Joe to proceed. Joe's crew spent the next few days rewiring the bathroom, removing the debris from their demolition work, and bringing in the materials they would need for the next phases of their work.

The following Monday, Joe went to Sarah's house and found that the key she had given him no longer worked. When he called her cell phone she explained that she had located another builder who was willing to make the cosmetic repairs she wanted without worrying about the problematic wiring. She thanked Joe for what he had done so far, but indicated she would no longer need his services.

Joe couldn't believe what he was hearing. His crew's labor so far already added up to $3000, and they had brought in another $3000 in materials. He was out money, time, the $4000 profit he had expected from Sarah, as well as the chance to take on a $10,000 basement renovation job that he had passed up because he was committed to working on Sarah's place.

If Joe sues Sarah what will he claim, and what counterclaims or defenses should he expect? Who is likely to win, and what damages, if any, might be awarded?