

4 TIPS FOR A BETTER LIQUIDATED DAMAGES CLAUSE

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This is another installment of *The Sanity Clause*, a regular column by Eric Fishman examining contract issues faced by in-house counsel.

If not carefully drafted, a liquidated damages clause can invite as much litigation as it eliminates. Consider a typical clause in which the parties stipulate to damages in the event of delayed delivery:

"If Seller breaches its obligation to deliver goods in accordance with the schedule provided for in this contract, Buyer shall have the option to recover \$x per day for each day of delay as liquidated damages."

Parties enter into such stipulations to eliminate disputes over the amount of damages, an expensive aspect of litigation often involving significant discovery and the retention of experts.

Although not as well-appreciated, a liquidated damages clause can also eliminate disputes about mitigation. As a general rule, a breaching party cannot seek to reduce or avoid the payment of liquidated damages by claiming that the aggrieved party failed to mitigate; that would undermine the predictability that such clauses are supposed to ensure. See 24 Williston on Contracts §65.31 (4th ed. 2013).

While plainly of value, liquidated damages clauses also serve as a sort of

lightning rod for litigation, frequently striking the breaching party as excessive when a default later occurs.

There are four types of challenges commonly raised to such clauses, which give rise to four drafting techniques that should be considered when negotiating the terms of such a liquidated damages provision:

1. Use caution in drafting liquidated damages clauses that are optional in nature

In litigation, the first thing that a breaching party would likely challenge with respect to the above-stated liquidated damages clause is the option of the buyer to resort to it. While a few courts have ruled that sophisticated parties may agree to optional liquidated damages clauses, see, e.g., *Avery v. Hughes*, 661 F.3d 690 (1st Cir. 2011), the majority rule is that such clauses are unenforceable. Were the rule otherwise, the clause would be "invoked only as a penalty when the liquidated damages exceeded the actual damages." *Grossinger Motorcorp., Inc. v. American Nat'l Bank & Trust Co.*, 180 Ill. Dec. 824 (Ill. App. 1992); see also *Stock Shop, Inc. v. Bozell and Jacobs, Inc.*, 126 Misc.2d 95 (N.Y.Sup.Ct. 1984); J. M. Perillo, Calamari and Perillo on Contracts

§14-32 (6th ed. 2009) (optional liquidated damages provisions “have been struck down as they do not involve a reasonable attempt definitively to estimate the loss”). As a general rule, therefore, avoid using optional liquidated damages clauses.

If, however, drafters are in a jurisdiction where this issue has not been squarely addressed and they nonetheless wish to include an optional liquidated damages clause, consider incorporating the following saving provision:

“In the event the liquidated damages clause set forth herein is found to be penal in nature because it gives the aggrieved party the option to invoke it, the parties agree that the liquidated damages provision shall apply and the option shall be null and void.”

2. Specify the damages that the parties intend to liquidate

Parties often fail to give sufficient consideration to the types of damages they intend to liquidate. For example, assume the seller in our hypothetical liquidated damages clause is a manufacturer of widgets and the buyer is a wholesaler. In one scenario, the manufacturer’s delay may cause the wholesaler to be late with respect to its own downstream performance. Such a wholesaler may suffer some reputational harm or even have to pay delay damages to its own customer (the retailer), but the downstream transaction will nonetheless proceed. By contrast, in another scenario, the manufacturer’s delay may cause the wholesaler completely to lose its resale to the retailer.

As these damages outcomes can be dramatically different, careful consideration should be given at the time of drafting to specify just what types of losses are and are not being liquidated. To address the situations just mentioned, for example, the parties may wish to include a provision along the following lines:

“The liquidated damages clause herein is intended to cover reputational and other losses suffered by the Buyer in the event the Seller’s delay does not cause the Buyer to lose an existing resale of the widget. This liquidated damages provision shall not apply in the event Seller’s delay causes Buyer to lose a sale on an existing contract.”

3. Incorporate the rationale for the clause into the clause itself

Liquidated damages clauses are enforceable in most jurisdictions, provided that, at the time of contracting, (i) it was difficult to quantify actual damages, and (ii) the agreed upon sum bears a reasonable relationship to those anticipated damages.

As might be expected, in litigation, a breaching party will often contend that these conditions were not satisfied, which raises an obvious (but often looked) drafting tip: Set forth the rationale for the clause in the clause itself.

Thus, for example, the above-stated liquidated damages provision might be supplemented as follows:

“The parties agree that quantifying losses arising from Seller’s delay is

inherently difficult insofar as delay may impact the Buyer’s reputation or require the Buyer to provide non-monetary concessions (such as a loaner widget) to its own customer, and further stipulate that the agreed upon sum is not a penalty, but rather a reasonable measure of damages, based upon the parties’ experience in the widget industry and given the nature of the losses that may result from delay.”

While such a provision does not guaranty the enforceability of the clause, it will certainly undermine the aggrieved party’s ability to contend that the clause was not reasonable at the time of contracting.

4. Give consideration to specifying the events intended to trigger the clause

The final area of common disagreement over liquidated damages clauses concerns whether the conditions necessary to trigger the clause have been satisfied. This issue most often arises in two situations. In the first, the seller is technically on time, but the goods cannot be used for other reasons—for example, due to regulatory approvals that have not yet been received. A well-drafted delay liquidated damages clause will specify whether it applies when delay is caused by a third party (here, the regulator) rather than the seller.

In the second situation, disputes arise over whether “concurrent delay” is the type of delay for which the buyer can invoke the clause. If, to continue with our example, a manufacturer is delayed by a month because of a

work stoppage, but the wholesaler also caused concurrent delay by failing to provide specifications and other information needed by the manufacturer during that same period, is there compensable delay? While the law provides divergent answers to this issue in different jurisdictions, the loss itself can and, ideally, should be allocated in the clause itself.

Putting all of these lessons together, a more robust liquidated damages clause might read something like this:

“If Seller breaches its obligation to deliver goods in accordance with the schedule provided for in this contract, Seller shall pay Buyer \$x per day for each day of delay as liquidated damages. The parties agree that quantifying losses arising from Seller’s delay is inherently difficult insofar as delay may impact the Buyer’s reputation or require the Buyer to provide non-monetary concessions (such as a loaner widget) to its own customer, and further stipulate that the agreed upon sum is not a penalty, but rather a reasonable measure of damages, based upon the parties’ experience in the widget industry and given the nature of the losses that may result from delay. This provision shall [shall not] apply in the event of concurrent delay

or delay caused by a third-party. The parties further agree that this liquidated damages provision shall not apply in the event Seller’s delay causes Buyer to lose a sale on an existing contract.”

By (i) eliminating the optional nature of the clause, (ii) specifying the rationale for liquidating damages, (iii) identifying the types of losses to be liquidated (and not to be liquidated), and (iv) clarifying the events that will (and will not) trigger the clause, drafters can significantly reduce the types of litigation that commonly attend liquidated damages clauses.

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