

DRAFTING THE LIQUIDATED DAMAGE CLAUSE— WHEN AND HOW

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Your client is selling his home for \$25,000. He proposes that the contract of sale call for a "down payment" of \$1,000, and that it stipulate the forfeiture of this sum if the buyer fails to consummate the purchase by paying the balance of the purchase price within the agreed twenty days. Will the provision be valid? In what words should it be expressed? Will the answer to the first question be different if the amount of the "down payment," and of the stipulated forfeiture, is \$10,000 instead of \$1,000? (Answer: Yes, probably, as we shall see later.)

The same questions arise when the proposal is that the parties stipulate that a specified sum shall be paid by the contractor for each day after a specified date that construction is delayed.

Provisions for liquidated damages are quite common in construction contracts for breach of time-of-completion covenants. Even more frequently, they are used in contracts for the purchase and sale of real property and of personal property. In the latter, they are usually expressed as provisions for forfeiture of earnest money, without being categorized as agreements to liquidate damages. Other possible uses are myriad.

In all cases, before determining whether to draft and how to draft a provision for liquidated damages, the draftsman must know when they are valid. To know that, he must know what tests the courts apply in making their determinations. He must know what his client's position will be if such a provision is held unenforceable. He should know whether such provisions are more likely to be upheld when they apply to the breach of a particular type of covenant than when they apply to the breach of another type. He should know whether, if the provision is tested in the judicial crucible, a satisfactory result will be more likely if the provision is expressly characterized as one for liquidated damages. He should consider whether to incorporate recitals of the parties' intentions, of the possible adverse impact upon the promisee of a breach, and of the fact that ascertaining the amount of damages will be difficult.

Finally—and of great practical importance—if the bargain has not been finally negotiated, what will be the "price" impact of the provision?

It is beyond the scope of this article to set forth a detailed analysis and documentation of the substantive law on this subject.¹ Our primary

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¹ See, generally, the works of writers on contracts and damages, such as CORBIN, *CONTRACTS* (1950). See also, 25 C.J.S. *Damages* §§ 101-16 (1941).

purpose is rather to determine and assemble some of the precepts for the draftsman that may be drawn from the legal literature on the subject. They will follow. However, since the legal guideposts and warning signals must be firmly in mind when one drafts in this area, a summary of the relevant law is essential.

VALIDITY OF PROVISION—PENALTY?

Penalties Are Not Enforceable

Subject to some limitations, bona fide agreements between contracting parties fixing the amount, or establishing a means of subsequently fixing the amount, of the damages to accrue to one party in the event of a breach of a covenant by the other party are valid and enforceable. Within the established limitations, parties are as free to contract on this matter as any other. However, the courts of all American jurisdictions will hold invalid and unenforceable covenants which they characterize as penalties for breach of contract. In fact, in earlier years, they demonstrated great zeal in "relieving against" such provisions, tending to resolve doubts in favor of characterizing the provisions as ones for penalties rather than for liquidated damages.² In more recent years, however, that tendency seems to be substantially abated, with increasing recognition that the parties, acting dispassionately before controversy has arisen between them, are often more competent than are judges and juries to assess the amount of damages for a particular breach of a particular covenant, and that encouraging them to do so by upholding their bargains tends to reduce the strife and expense of litigation.³

² The history of the growth of the principle that equity will prevent the enforcement of penalties is set forth briefly at 25 C.J.S. *Damages* § 101(c) (1941).

³ "There are, no doubt, decided cases which tend to support the contention advanced by appellant, but these decisions were, for the most part, rendered at a time when courts were disposed to look upon such provisions in contracts with disfavor and to construe them strictly, if not astutely, in order that damages, even though termed liquidated, might be treated as penalties, so that only such loss as could be definitely proved could be recovered. The later rule, however, is to look with candor, if not with favor, upon such provisions in contracts when deliberately entered into between parties who have equality of opportunity for understanding and insisting upon their rights, as promoting prompt performance of contracts and because adjusting in advance, and amicably, matters the settlement of which through courts would often involve difficulty, uncertainty, delay and expense. . . . The parties to the contract, with full understanding of the results of delay and before differences or interested views had arisen between them, were much more competent to justly determine what the amount of damage would be, an amount necessarily largely conjectural and resting in estimate, than a court or jury would be, directed to a conclusion, as either must be, after the event, by views and testimony derived from witnesses who would be unusual to a degree if their conclusion were not, in a measure, colored and partisan." *Wise v. United States*, 249 U.S. 361, 365-67 (1919). See also 25 C.J.S. *Damages* § 102(b) (1941).

The authorities generally distinguish between liquidated damages as being a genuine pre-estimate of damages, and a penalty as being a provision which operates *in terrorem*, by "penalizing for breach," "as punishment," or as a "deterrent." Absent infrequent statutory limitations, the courts rely upon the two basic tests of validity hereafter described, often additionally paying lip service to the "intention of the parties."

First Test—Reasonableness of Amount or Formula

The *Restatement* succinctly encapsules the courts' first test of the validity of a covenant claimed to be for liquidated damages by saying that the amount thereby fixed must be "a reasonable forecast of just compensation for the harm that is caused by the breach. . . ." ⁴ In enunciating this test, courts and writers use terms such as "honest" and "reasonable" estimates of damages or "attempts at pre-estimation." If an amount prescribed as purported liquidated damages, by the measure normally applicable, ⁵ is obviously excessive, the courts will characterize it as a penalty and hold the provision invalid. ⁶ (Questions as to possible varying degrees of disparateness, who has the burden of showing it, and the extent to which the courts will indulge rebuttable presumptions of the reasonableness of the parties' determination are outside the scope of this writing.)

Is the reasonableness of the amount or formula prescribed to be judged in the light of the situation as viewed by the parties at the time they made their contract, or is it to be judged in the light of conditions existing at the time of or after the breach? While some of the earlier cases ignored this question, and proceeded to apply the test by hindsight, when the question has been expressly considered it has nearly always been held that reasonableness is to be judged as of the time of the making of the contract. ⁷

Second Test—Difficulty of Ascertaining Damages

Fostered undoubtedly by the historical reluctance of courts to enforce liquidated-damages covenants, the rule has become firmly established that such a covenant is not enforceable unless "the harm that is caused by the breach is one that is incapable or very difficult of accurate estimation." ⁸ To illustrate, damages for failure to pay a promised sum

⁴ RESTATEMENT, CONTRACTS § 339 (1932).

⁵ "In determining the amount of this compensation [for breach of contract] as the 'damages' to be awarded, the aim in view is to put the injured party in as good a position as he would have had if performance had been rendered as promised." 5 CORBIN, CONTRACTS § 992 (1951). The general rule is stated at RESTATEMENT, CONTRACTS § 329 (1932).

⁶ 25 C.J.S. *Damages* § 108 (1941).

⁷ *E.g.*, *Wise v. United States*, *supra* note 3.

⁸ RESTATEMENT, CONTRACTS § 339 (1932).

of money when due are measured by the legal rate of interest. A simple mathematical computation, after breach, will result in a precise ascertainment of the damages. An agreement to liquidate damages for such a breach is invalid.

A second illustration: If the circumstances are such that a promisee's compensation for breach of a promise to deliver a specified number of shares of a stock actively traded upon an exchange would be based upon the value of that stock at a particular time, that value could be accurately computed, after the breach, by reference to readily available stock-price quotations. An agreement for liquidated damages in this case would be invalid. The result should be different, however, if the parties were to agree that for the purpose of measuring the promisee's damages in the event of a breach by the promisor the value of the stock of a closely held corporation, for which no active market exists, is a specified sum (assuming of course that the sum specified be a reasonable one; probably meaning, in this case, within the upper and lower limits of a rational determination of value for the particular stock).

Since the agreement liquidating damages must be reasonable, in the light of the rules of law for measuring damages, the draftsman of such an agreement cannot proceed with his drafting until he knows how the damages for a particular breach of a particular covenant would be measured in the jurisdiction whose law would control in the event of an action for recovery of damages.

To what extent is the element of foreseeability of harm from a specified breach of a particular covenant relevant to drafting an agreement liquidating damages for that breach? The answer is that it is probably no more relevant than in the case of a post-breach ascertainment of allowable damages.⁹ Hence, the careful draftsman will seek to anticipate whether the promisor might subsequently contend that the parties had not at the time of making their contract foreseen that particular consequences would flow from the promisor's breach. He can then incorporate a suitable recital in his contract to make it plain that the parties did, in fact, foresee particular consequences.

When shall the determination be made as to whether it will be difficult to ascertain the amount of damages? Since the answer may establish the validity of the stipulation as of the time of the making of the contract, that is the time as of which the determination should be

⁹ "A contract-breaker can be charged with the amount of an expected gain that his breach has prevented, if when the contract was made he had reason to foresee that his breach would prevent it from accruing. He can be charged with an expenditure made in reliance on the contract if he had reason to foresee that it would be incurred and that his breach would make it futile." 5 CORBIN, CONTRACTS § 992 (1951). Generally, on the factor of foreseeability, see *id.* §§ 1007-10, 1012, 1013.

made. When the problem has been squarely considered, it has been so resolved.¹⁰

Intention of Parties

The opinions of the courts dealing with the validity of covenants purportedly for liquidated damages are replete with discussions about the "intention of the parties." Time and again they are found to say that a covenant specifying a sum to be paid in the event of a breach will be deemed to be one for liquidated damages if the parties so intended; otherwise, a penalty. Rarely is there any doubt about what the parties intended. If the agreement is to the effect that if *A* fails to perform as promised he shall pay *Y* dollars to *B*, that is what they meant. What is there to construe? Contracting parties—businessmen, usually—do not contract in terms of legal doctrines. They have never heard of the proposition that "equity will relieve against a penalty." When they say that under specified circumstances one man shall pay another a sum of money, that is just what they intend.

The courts, however, in vast majority in the past, have proceeded, in terms of the example above given, first to determine whether *Y* dollars was a reasonable amount in relation to the harm done to *B* by *A*'s failure to perform his promise. If they have concluded that it was reasonable, they have solemnly opined that it was the intention of the parties that *Y* dollars should be "liquidated damages." If they have determined that it was not reasonable, they have said, often squarely in the face of an express declaration that *Y* dollars is fixed as "liquidated damages," that the parties intended that the payment of *Y* dollars should be a "penalty," serving as a club to compel performance by *A*.

The true rule surely is that the intention of the parties in this regard is irrelevant; that the law, as a matter of public policy, imposes a limitation upon the freedom of the power to contract, and that if a contractual provision is not within the limitation it is invalid.¹¹

Same Liquidated Damages for Several Breaches

When two or more separate obligations are to be performed by a contracting party, appropriate damages for the breach of one of them would not ordinarily be the same as for the breach of another. There-

¹⁰ "In determining whether the sum provided to be paid in the contract is liquidated damages, or a penalty, a court will construe the contract by its four corners in the light of the situation of the parties at the time of the execution of the contract, and from that position will determine whether the damages which would be sustained by reason of breach could, by the process of computation and adjustment, have been easily and approximately ascertained at the time of execution of the contract. . . ." *Miller v. Blockberger*, 111 Ohio St. 798, 807, 146 N.E. 206, 209 (1924). To the same effect, see 5 CORBIN, CONTRACTS § 1060 (1951).

¹¹ "Intent is of no practical importance. The question is not what the parties intended, but 'whether the sum is in fact in the nature of a penalty.'" *Central Trust Co. v. Wolf*, 255 Mich. 8, 237 N.W. 29, 78 A.L.R. 843 (1931). See 78 A.L.R. 846 (1932).

fore, a sum as stipulated damages which would meet the test of reasonableness as to the breach of one covenant would be unlikely to meet that test with respect to the breach of another. Generally speaking, therefore, a single stipulation with respect to more than one breach will be held invalid,¹² unless, possibly, the provision is determined to be reasonable as to *each one* of the designated breaches.¹³

Specific Sum Versus Formula

Will a contractual stipulation be valid if instead of specifying a definite single sum to be paid by the defaulting party it sets forth a formula or measure or basis to be used subsequent to the breach in computing the amount to be paid? Yes, even though an occasional aberrant decision may be found.¹⁴ Such provisions are frequently used, and are often eminently satisfactory.

Relevant Statutes

Pertinent statutes applying to liquidated-damages covenants are a comparative rarity, but the draftsman should always verify their existence or nonexistence. For example, California and Oklahoma have provided that liquidated-damages agreements are void except in cases in which it is impracticable or extremely difficult to ascertain actual damages.

¹² 25 C.J.S. *Damages* § 111 (1941).

¹³ *Ann Arbor Asphalt Constr. Co. v. City of Howell*, 226 Mich. 647, 198 N.W. 195 (1924); Comment, *Functional Approach in Determining the Validity of a Liquidated Damage Clause*, 30 TEX. L. REV. 752, 753 (1952).

¹⁴ *E.g.*, *Midwest Properties Co. v. Renkel*, 38 Ohio App. 503, 176 N.E. 665 (1930). The court said: "In the case at bar the provision calls for reasonable attorney fees, without specifying the amount. It . . . leaves in an uncertain state the amount that courts and juries will regard as reasonable attorney fees. This provision cannot be regarded as one of liquidated damages, because the amount is left uncertain, and still calls for future action by courts and juries to determine what, in their opinion, are reasonable attorney fees." *Id.* at 513, 176 N.E. at 669. The court did not refer to, and presumably was unaware of, the holding of the Ohio Supreme Court in *Sheffield-King Milling Co. v. Domestic Science Baking Co.*, 95 Ohio St. 180, 115 N.E. 1014 (1917), wherein the court said: "Where the parties to a contract deem it advisable, the law permits them to stipulate in advance what the damage, or the measure thereof, shall be in case of breach by either." (Emphasis added.) The holding in *Midwest Properties* is *contra* that of the United States Supreme Court in *Irving Trust Co. v. A. W. Perry, Inc.*, 293 U.S. 307 (1934), wherein the lease in question provided that the filing of a petition in bankruptcy by or against the lessee "shall be deemed to constitute a breach of this lease, and thereupon ipso facto . . . this lease shall become and be terminated; and the Lessor shall . . . be entitled to recover damages for such breach in an amount equal to the amount of the rent reserved in this lease for the residue of the term thereof less the fair rental value of the premises for the residue of the term." Mr. Justice Roberts, for the Court, concurred in the circuit court's view that "the clause provided a reasonable formula for ascertaining the damages of the landlord, did not smack of a penalty, and was therefore enforceable."

Statutes providing for the awarding of public contracts by competitive bidding often require that bidders deposit a sum of money which shall be forfeited under specified conditions, such as that, if the depositor be awarded the contract, he thereafter fails within a time limited to sign a formal written contract and secure its performance.¹⁵ Such requirements are apparently well-nigh universally upheld, often without any consideration of the question whether they constitute requirements for the payment of liquidated damages or provisions for penalty. Perhaps the question is irrelevant in such a case on the theory that the legislature has established an exception to the general public-policy rule which applies in the case of private contracts; that is, that the legislature has declared a different public policy to prevail in relation to such public contracts. In some cases the courts will characterize the forfeiture of the bidder's security as being in the nature of liquidated damages.¹⁶

Statutes relating to public contracts may provide for relief against the usual consequences of a liquidated-damages stipulation.¹⁷

Consequences of Invalidity

If a provision specifying a payment by the promisee upon breach of his covenant is held to be invalid as constituting a penalty, the legal effect is as though it were expunged from the contract. The validity of the remainder of the contract is not impaired. In the event of breach the promisor may recover whatever damages he would be entitled to under the law if the provision had not been incorporated in the contract.¹⁸

CHARACTERIZING AGREEMENT AS ONE FOR LIQUIDATED DAMAGES

What is the effect of a statement in a contract that a stipulated sum shall be paid "as damages" or "as liquidated damages" or "as compensation for the resulting damage"? It was observed above that the intention of the parties in this regard, as indicated by such expressions, is, or at least should properly be regarded as, irrelevant to the issue of validity of the agreement. The ultimate characterization of the nature of the promised payment will, in the event of dispute, be by the court, irrespective of the parties' characterization.

When the provision is one that will be enforced by the court, the amount specified therein is called liquidated damages. In cases where enforcement is denied, it is said that the parties have provided for a penalty or a forfeiture.¹⁹

In this posture of the law, should the draftsman characterize his stipulated payment in such terms "as liquidated damages," or "as dam-

¹⁵ *E.g.*, OHIO REV. CODE § 731.15 (1953).

¹⁶ *E.g.*, *Village of Pomeroy v. Ringwald*, 13 Ohio App. 367, 31 Ohio C.C.R. (n.s.) 444 (Ct. App. 1920).

¹⁷ *E.g.*, 41 U.S.C. § 256a (1950).

¹⁸ See cases cited at 25 C.J.S. *Damages* § 116(b) n.87 (1941).

¹⁹ 5 CORBIN, CONTRACTS § 1058 (1951).

ages and not as a penalty"? The answer is yes. It can do no harm, and may possibly be helpful.²⁰ One reason is that it may give a court which is already disposed to uphold the provision an additional peg upon which to hang its decision. Mr. Justice Clarke, speaking for the United States Supreme Court in upholding a contractual stipulation of damages, pointed out that "the parties specifically state that the amount agreed upon as liquidated damages had been 'computed, estimated and agreed upon' between them."²¹ If a court construing the provision should be one that pays lip service to the "intention of the parties" test, the presence of an appropriate characterization may make it easier for it to render a favorable decision.

Generally in a jury trial, the question whether an agreement to pay a stipulated sum is one for liquidated damages or in the nature of a penalty is held to be one for the court; however, in some jurisdictions it is held to be one of fact for the jury.²² If a contract should come before a court in such a jurisdiction, the characterization by the parties might be persuasive to the jury.

INTEREST ON LIQUIDATED DAMAGES

In most jurisdictions interest on damages for breach of contract is allowed from the date when payment was due if the demand sued upon was liquidated.²³ Conversely, it is ordinarily not allowed for the period prior to judgment upon claims for unliquidated damages.²⁴ In the event of breach and necessity of suit to collect damages, will a covenant for liquidated damages enlarge the plaintiff's recovery by interest between date of breach or demand and judgment date? (With a lapse of sometimes several years between filing of suit and rendition of judgment, this could substantially increase the aggrieved party's recovery.) On principle, the answer should be yes.²⁵ And it has been so held,²⁶ although there is authority to the contrary.²⁷

²⁰ 25 C.J.S. *Damages* § 105 (1941).

²¹ *Wise v. United States*, 249 U.S. 361, 366 (1919).

²² 25 C.J.S. *Damages* § 102(a) (1941).

²³ 25 C.J.S. *Damages* §§ 51, 52 (1941).

²⁴ *Id.* § 52.

²⁵ "In all jurisdictions, simple interest at the statutory legal rate is recoverable as damages for non-payment of a liquidated debt from the date of breach if the parties involved have not themselves provided otherwise by contract. As used in this connection, the term 'liquidated debt' has a much broader signification than it is frequently given in other places. It includes not only all legal duties to pay a definite and undisputed amount of money; it includes also a duty to render any performance the value of which in money is stated in the contract itself. If damages that would have been too uncertain in amount have been liquidated at a certain amount by agreement, interest is recoverable from the date when that amount was payable." 5 CORBIN, *CONTRACTS* § 1046 (1951).

²⁶ 25 C.J.S. *Damages* § 116(a) n.76 (1941).

²⁷ *Id.* n.77.

ACTUAL DAMAGES REQUIRED?

Must a plaintiff suing on a covenant for liquidated damages prove not merely the breach but also that he has actually been damaged, in order to prevail? The majority rule appears to be that he need not prove actual damage.²⁸ In one state, it has been held that in a case in which the obligee shows no injury he can recover the stipulated sum as liquidated damages only if there was a further agreement that the sum was to be paid regardless of injury. Some states take the approach that there is a presumption of law that a breach results in damages, and that for a prima facie case the plaintiff need not prove either that he sustained actual damage, or that if he did the amount thereof was substantial and not merely nominal, but that if it is made affirmatively to appear that the plaintiff sustained no damages the provision for liquidated damages cannot be enforced.²⁹

Some courts not following the majority rule apparently do not even recognize the question in the terms above stated. If there be no actual damage sustained, the provision will be deemed one for a penalty, rather than liquidated damages.³⁰

OTHER PROBLEMS ARISING AFTER AGREEMENT MADE

Above we considered briefly the question of the necessity of proving actual damage in order to recover under an agreement liquidating damages. We did so because it points up the fact that, in many jurisdictions, an enormous practical advantage of such an agreement may be to simplify or eliminate problems of proof if the promisee must sue on his contract. Also, drafting suggestions are implicit.

Numerous other types of problems can arise during operations under a contract carrying a stipulation for liquidated damages, or after breach. Especially is this the case under construction contracts providing for liquidated damages in the event of delay in completion of work. For example, the question often arises as to the effect upon the promisee's right to recover liquidated damages for delays occasioned by him or a third person.³¹ Alterations and additions performed at his instance may or may not have required more time in construction. Sometimes the acts of both parties contribute to delays, and in such case questions of apportionment may arise. Such contracts sometimes contain provisions for time extensions under stipulated circumstances. What is the effect of a complete abandonment of the work by the contractor, so that in effect his delay in completion will extend in perpetuity?

²⁸ Annot., 34 A.L.R. 1336, 1341 (1925); 25 C.J.S. *Damages* § 115(d) (1941).

²⁹ 25 C.J.S. *Damages* § 115(d) (1941).

³⁰ *Dunn v. Morgenthau*, 73 App. Div. 147, 76 N.Y. Supp. 827 (1902), *aff'd* 175 N.Y. 518, 67 N.E. 1081 (1903). See Annot., 34 A.L.R. 1336, 1338 (1925).

³¹ See Annot., 152 A.L.R. 1349 (1944).

The reader's attention is directed to these problems, but because they are largely collateral to the subject of this article, and because another writer has recently addressed himself specifically to them,³² they will not be examined here.

GUISES AND DISGUISES

As a general rule, any contractual arrangement whereunder a promisee is to receive a specified sum of money, or a sum of money to be computed in some specified manner, must meet the tests for a valid agreement liquidating damages, else it will be held invalid as providing a penalty. The obvious case is that of an agreement by the promisee to pay a sum of money to the promisor after the promisee's default. A somewhat less obvious, but very common, case is that whereunder a purchaser of property pays earnest money to the seller, with the stipulation that if the purchaser fails to consummate the purchase by paying the balance of the purchase price within a stipulated time the earnest-money payment shall be forfeit. Commonly, such contracts do not characterize the forfeiture as being in the nature of liquidated damages, but the amount of it must meet the test of reasonableness and the circumstances must be such that the damages from the breach would be at least difficult accurately to determine; otherwise the forfeiture will be judicially stricken down. The rule is not changed by the intervention of a third party as a stakeholder in such a case.

A provision may be for the forfeiture of property other than money.³³

Contracting parties' lawyers have been ingenious and occasionally ingenuous in cloaking penalty provisions in other forms, sometimes with success in the courts. For example, in one type of case, in which the promisor's obligation is simply to pay a specified sum of money at a specified time, without interest if so paid, the instrument further provides that if payment is not made when due, then interest shall be paid at a specified (nonusurious) rate from the inception of the obligation and not merely from the due date. Under one line of cases such a stipulation will be stricken as imposing a penalty—that is, the interest from inception to due date—based on the rule that the only measure of damages for the withholding of money is interest commencing at the time payment is due is withheld; but under another line of cases such provisions are enforced as constituting valid agreements to liquidate damages.³⁴ Comparable problems, with varying results in the cases, are presented by stipulations for a higher rate of interest after maturity,

³² Anderson, *Liquidated Damage Problems in Construction Contracts*, 5 *PRAC. LAW.* 72 (1959).

³³ 5 *CORBIN, CONTRACTS* § 1057 (1951).

³⁴ Annot., 12 *A.L.R.* 367, 374 (1921).

for a higher rate of interest after default in paying interest, and for a higher rate of interest retroactively from inception in cases of default.³⁵

The validity of provisions in bills and notes for the payment of the holders' attorney fees and other costs of collecting is determined on the basis of the tests for valid liquidated-damages stipulations, with varying results in different jurisdictions.³⁶

Other variants from expressly labelled stipulations for liquidated damages or penalties are frequent. One arrangement is to provide that a specified sum shall be paid for performance by a stipulated date, and a greater sum for performance by an earlier date. If the differences in time and sums payable are reasonable, the arrangement will usually be upheld upon the theory either of reasonable liquidated damages for failure to complete by the earlier date, or of a payment of a premium price for a better bargain. However, if the price disparity is great in relation to total contract price, so that it appears that the parties' real objective was that performance should be rendered by the earlier date, the difference between the alternative prices is likely to be held to be a penalty.

The same basic tests are applied in determining the validity of alternative covenants that purport to give the contracting party the choice of paying a sum of money or of rendering some specified other performance.³⁷

ADVANTAGES OF LIQUIDATED DAMAGES PROVISIONS

We are now in a position to catalog some of the advantages which may accrue to one or both of the parties to a contract from the inclusion of stipulations for liquidated damages for one or more specified breaches.

(1) Often the determination of the amount of damages to be awarded for a breach of contract involves much expense and difficulty during the course of, and in preparation for, the litigation thereon. These are avoided or reduced substantially.

(2) In some jurisdictions, a stipulation may assure recovery when it would be difficult or impossible for the promisee to prove that he sustained actual damage or, if so proven, that the damage was substantial.

(3) In most of the cases and jurisdictions, inclusion will assure the plaintiff's right to recover interest from the date of breach or demand, rather than merely from the date of judgment.

(4) Other benefits may flow from the fact that the amount of the damages is liquidated earlier in point of time than the rendition of judgment. For example, in one case it made the claim for damages provable in bankruptcy, when otherwise it would not have been.³⁸

³⁵ Annot., 12 A.L.R. 367, 369, 372 (1921); 25 C.J.S. *Damages* § 113(b) (1941).

³⁶ 7 AM. JUR. *Bills and Notes* §§ 138-42 (1937).

³⁷ 25 C.J.S. *Damages* § 110(d) (1941).

³⁸ *Irving Trust Co. v. A. W. Perry, Inc.*, 293 U.S. 307 (1934).

(5) From the standpoint of the party who promises to pay liquidated damages, while the provision may make it more certain that he will have to pay in the event of his breach, a valid provision establishes a firm maximum limit upon the amount of his obligation.

(6) The promisee under such a provision has some practical assurance, from the very fact of its incorporation in the contract, that the other party realizes that his default will be costly to him, thus having some of the deterrent effect of a penalty. This is especially likely to be the case if there have been substantial negotiations over the provision, for then the prospective defaulter will have the provision firmly in mind.

WHEN TO USE LIQUIDATED DAMAGES PROVISIONS IN CONTRACTS

The use of such a provision should be considered in any situation in which it appears likely at the time the contract is drawn that it would be difficult, after a breach, to ascertain the amount of damages. It should especially be considered in any situation in which any of the advantages above enumerated might be present.

From the standpoint of either party the use of the provision might achieve what is surely always a basic purpose, that is, to eliminate or reduce the time and expense of litigation over damages.

The draftsman should ordinarily not refrain from using the provision in an otherwise suitable case just because the contract is entered into in a jurisdiction in which the particular provision might be unenforceable. In most cases it will be possible, and in many will be likely, that an action on the contract would be brought in some other jurisdiction where the provision would be enforceable. (Problems of conflicts of laws will not be considered here. For current purposes it is enough to assume that situations will sometimes exist under which the law of some jurisdiction other than that in which the contract is entered into will control for the purpose of an adjudication on the validity of a liquidated-damages provision.) A simple illustration may be given. In Ohio a stipulation in a promissory note for the payment of the holder's attorney fees, if the note be not paid at maturity, is held to be void as contrary to public policy,³⁹ although Section 2 of the Uniform Negotiable Instruments Law,⁴⁰ prevents such a stipulation from destroying the negotiable character of an instrument.⁴¹ However, such stipulations are enforceable in various other jurisdictions.⁴² It is entirely possible, especially in the case of a note made in Ohio but delivered or payable, or

³⁹ *Miller v. Kyle*, 85 Ohio St. 186, 97 N.E. 372 (1911).

⁴⁰ OHIO REV. CODE § 1301.06 (1953).

⁴¹ *Miller v. Kyle*, 85 Ohio St. 186, 97 N.E. 372 (1911).

⁴² 7 AM. JUR. *Bills and Notes* §§ 138-42 (1937).

both, in another state, that an action to collect on the note would be prosecuted in some other state.

Practical considerations may be far more important, in many cases, than purely legal considerations, in determining whether a liquidated-damages provision should be used. The psychological impact upon the potential defaulter of discussions during negotiation about the amount of damages that might result from his default may substantially diminish the likelihood that he will breach his contract. Undoubtedly, many laymen are unaware of the legal consequences of failing to keep their bargains, and anything that tends to drive home an understanding that those consequences can be serious may tend to make them strive harder not to fail.

Counsel should be alert, no matter which party he represents. Occasions can arise in which it may be greatly to the interest of the party who is the potential payor of damages to insist upon the inclusion of a damages-liquidating clause in his contract. Such an occasion will exist when (1) there is substantial danger that the party may not be able to avoid breaching his promise and (2) the situation is such that the damages to the other party might be very large. At the contract-negotiating stage, the other party may be willing to stipulate damages at a reasonable, bearable level.

Just as there are some situations in which it is highly advantageous to one party or the other, or to both, to incorporate one or more provisions for liquidated damages in their contract, so there are other circumstances in which such incorporation may be either in vain or, from the standpoint of at least one of the parties, unwise. What are (to borrow the physicians' term) some of the contraindications? Most obviously, such a provision should not be used in a case in which it will be invalid because the determination of damages after the breach will be simple and easy. There is a danger in using the provision in a case in which the validity of the provision is subject to considerable doubt—a borderline case—because in that circumstance, instead of reducing the time and expense of potential litigation, it is likely to induce litigation, or to introduce new problems in any litigation that might otherwise ensue.

Purely practical considerations may dictate the nonuse of the provision in a case in which it would, from a legal standpoint, be apparently desirable to use it. For example, a few years ago a public agency was in the course of taking bids, over a period of months, upon a series of large construction contracts. When bids were received upon some of the first of these contracts there were indications that many of the bidders might be, and probably were, increasing the amounts of their bids substantially because of the presence in the contracts of provisions for the payment by the contractors of liquidated damages in the event of noncompletion of construction by specified dates. The public agency involved concluded that it would have to pay too high a price for the

benefits that it might derive from these provisions, and in contracts subsequently let these provisions were omitted.

This problem of the "price" to be paid by the promisee under a stipulation for liquidated damages for breach of contract is one that may arise with respect to almost any type of contract, whether or not negotiated between private parties. It has been the writer's observation that in situations in which the use of such provisions is quite customary, little has to be "paid" by the promisee to obtain the benefits of such a provision, while in circumstances in which no prevailing custom exists much more resistance may be encountered, with consequent demand by the promisor of an additional *quid pro quo*.

There are dangers in a draftsman's too offhandedly fixing an amount or prescribing a formula, without adequate consideration of the potential consequences of a breach. There is a legal danger, for in such case the possibility is increased that the amount or formula will be held not to meet the reasonableness test. There is the practical danger, if the draftsman represents the beneficiary of a promise to pay liquidated damages, that he will overlook possible consequences of breach, and establish an inadequate figure or formula which will later, upon breach, result in his client's obtaining a wholly inadequate recovery, and one much less than he might have obtained had there been no stipulation liquidating damages.

In many situations the legal draftsman cannot afford to utilize an otherwise desirable provision in an instrument if there is any doubt whatsoever about its validity, because the consequences to his client might be too severe if the provision were ultimately held invalid; not so, in the case of a contractual stipulation for liquidated damages. Here he can proceed serenely, knowing, as previously indicated, that if the provision is some day held invalid his client will be no worse off (except for the added time and expense of the litigation producing the adjudication of invalidity) than he would have been had the provision been omitted.

SPECIFIC DRAFTING SUGGESTIONS

What precepts for the draftsman may we glean from prior experience with liquidated-damages stipulations in contracts? Some of them will be arrayed in the form of lists of things which the draftsman should do and things which he should not do.

Do's .

The draftsman should:

(1) Make sure that the damages stipulated will fall within the range between the upper and lower limits of potential actual damages foreseeable at the time of the making of the contract. Otherwise, the provision is likely to be held to be invalid as prescribing a penalty.

(2) See to it that the parties actually, seriously negotiate on the question of the amount or measure of the liquidated damages, with full

consideration of all foreseeable consequences of breach. Then, for added protection, incorporate in the contract recitals which will show that they have done so.

(3) If the contemplated breach is of a covenant which requires the party to perform a particular act within a time limit, provide suitable machinery for reasonable extensions to adjust for delays which may result from actions or derelictions of the other party or of third parties. Especially do so in construction contracts.

(4) Make the amount of damages agreed upon vary with the extent of the breach, such as the duration of the delay or period of default.⁴³

(5) Incorporate a suitable recital indicating that it was the intention of the parties to provide for liquidated damages; at least, characterize by using the words "liquidated damages." Before some courts, it may help.

(6) Recite the facts which caused the parties to incorporate the provision in the contract, such as that, for stated reasons, the amount of damages upon the breach will be very difficult to ascertain with precision.⁴⁴

(7) Consider incorporating factual recitals which can, in the event of a lawsuit, be pointed to in order to show that the breaching party had knowledge that specific types of substantial injuries would or might be sustained by the other party from the former's breach. (This can be "good medicine" in many contracts, with or without liquidated-damages provisions.)

(8) If a situation is otherwise one calling for a liquidated-damages clause, but it is not feasible at the time of drawing the contract to develop a satisfactory, reasonable, and equitable single sum to be paid, consider specifying a measure or formula by which damages can subsequently be computed.

(9) In the case of a construction contract providing for liquidated damages for delay in completion, consider adding a provision that the right to liquidated damages shall survive the contractor's complete abandonment of the work, and its completion by the owner.⁴⁵

Don'ts

Along with the do's, some don'ts are equally important to the draftsman:

⁴³ See 25 C.J.S. *Damages* § 112 (1941).

⁴⁴ *Id.* § 107.

⁴⁵ It may be desirable to be even more precise by establishing, in the case of damages-per-day-of-delay provisions, a maximum number of days to which it shall apply after a complete abandonment of the work. The problem of abandonment, and other problems arising in connection with construction contracts, are dealt with in Anderson, *Liquidated Damage Problems in Construction Contracts*, 5 PRAC. LAW. 72 (1959).

(1) Don't lightly approach, or permit the parties lightly to approach, the determination of the amount of the liquidated damages, or the formula for fixing them. The result may be fatal.⁴⁶

(2) Don't put in too small an amount when representing the party in whose favor the liquidated-damages provision runs. If it is valid, that is all he will ever get even though it turns out that the damages actually sustained and provable are much greater.

(3) Don't use words smacking of penalty. Certainly, don't use "penalty" or "penalize." To play safe, it may be better to avoid "forfeit" and "forfeiture;" they may have a connotation in some judicial minds that would be detrimental. Occasionally, judges have used "penalty" and "forfeiture" synonymously. (Say, instead, for example, that "if *B* breaches, *A* shall retain the sum aforesaid, and *B* shall have no right to its return.")

(4) Don't provide a single, lump sum as damages for delay, irrespective of the duration of the delay.

(5) Don't provide a single sum or measure of damages for breaches of two or more covenants; treat each potential breach separately, if more than one is to be provided for.

(6) Don't provide that in addition to a forfeited or other liquidated sum the injured party may recover actual damages or have some other specified remedy.⁴⁷

(7) Don't require any payment because of nonpayment of a sum of money when due, except interest at the legal rate after default, without ascertaining within what limits, if any, the proposed requirement will be enforceable in the jurisdiction or jurisdictions wherein enforcement of the obligation might likely be sought.⁴⁸

(8) Don't be too hopeful of success in avoiding the fatal "penalty" stigma by dressing the provision up in some other guise, although some cases of "discounts," "premiums," "alternative performances," "dual prices," and the like do pass judicial scrutiny. In a few instances, that may be because no "penalty" issue is raised. However, in most which do succeed, the reason is that the differences between the variants meet the reasonableness test and thus qualify as valid, liquidated damages although not so labelled.

⁴⁶ "[W]here it is apparent from the contract itself and the situation of the parties thereto that the sum stipulated was arrived at arbitrarily, and bears no relationship to the damage which probably would result from a breach, where such damage is reasonably ascertainable, the sum stipulated as damages will be considered a penalty and not liquidated damages. . . ." *Miller v. Blockberger*, 111 Ohio St. 798, 809, 146 N.E. 206, 209 (1924).

⁴⁷ *Hughes Bros. v. United States*, 45 Ct. Cl. 517 (1910).

⁴⁸ Annot., 12 A.L.R. 367 (1921).