



Using a Liquidated Damages Clause

IN MAJOR AGREEMENTS FOR THE SALE OF GOODS

By Bob Kenagy

Businesses entering into a significant agreement regarding the sale of goods should give careful consideration to negotiating a liquidated damages clause to better understand potential risks and liabilities in a breach situation. A well thought-out liquidated damages clause forces the parties to establish a sum they deem to be a reasonable estimate of the anticipated or actual harm arising out of a breach where damages are not easily calculable at the time of contracting.¹ While negotiating a liquidated damages clause can slow down negotiations and add some frustration to the initial contract formation process, it may well be worth accepting these initial hurdles to better protect the business in the long run. At a minimum, those responsible for the business enterprise should have the opportunity to better understand the terms of the deal and the potential risks involved in a major transaction.

For a buyer in a major sales agreement, a liquidated damages clause can clarify the consequences of a seller's failure to deliver a key component, such as severely disrupting the buyer's business by temporarily shutting down a manufacturing line or crippling

the buyer's ability to sell other products.² For a seller, a liquidated damages clause can enhance its ability to win important business by signaling its commitment to the buyer and to the transaction³ and can protect the seller when the seller is committing a significant portion of its assets to fulfilling an agreement and is concerned about exposure to an unquantified risk if there is a breach.⁴

Michigan has codified its common law regarding liquidated damages with respect to the sale of goods⁵ and adopted the Uniform Commercial Code's standard Article 2 language, at MCL 440.2718(1), which states:

Damages for breach by either party may be liquidated in the agreement but only at an amount which is reasonable in the light of the anticipated or actual harm caused by the breach, the difficulties of proof of loss, and the inconvenience or nonfeasibility of otherwise obtaining an adequate remedy. A term fixing unreasonably large liquidated damages is void as a penalty.

FAST FACTS

Focusing on a liquidated damages clause gives top management the opportunity to think hard about liability exposures.

Avoiding unpleasant liability surprises is worth the negotiating time.

A reasonable estimate of the anticipated loss is essential.

A well-constructed clause helps to ensure that courts honor the parties' freedom to apportion the risk of loss if a breach considered by the parties actually occurs, provided the sum established by the parties through good-faith negotiations is a reasonable estimate of damages that are difficult to ascertain at the time of contracting.⁶ While no specific language is required, a well-drafted clause should avoid ambiguities that force a court to substitute its judgment for that of the parties.⁷ If the breach is one that the parties did not anticipate or if the clause is ruled invalid, the clause will not apply and the parties will be left with traditional remedies under the law and the need to prove damages.⁸ As one would expect, liquidated damages may not be recovered by a party that is the cause of the breach or when the breach is due to the fault of both parties.⁹

Elements of a Liquidated Damages Clause

Both parties need to understand the elements of a valid liquidated damages clause to be sure that the clause is honored by a

court and not voided as a matter of law for being a penalty or for being unconscionable.¹⁰ As a fundamental first step, the parties need to negotiate the clause in good faith. Courts are receptive to the commercial reasonableness of a liquidated damages clause if there is evidence that the parties negotiated in good faith.¹¹ If there is a great disparity in bargaining power, the parties need to be especially careful in establishing evidence that they have fairly estimated the anticipated damages regarding a breach.¹² If the parties seriously negotiate a sum for the purpose of justly compensating the non-breaching party and document their basis for estimating that sum, a court should be satisfied that the clause is not a penalty.¹³ If a court perceives there was a lack of good faith in estimating what would be just compensation for the injured party, the clause will be viewed as unconscionable because just compensation is the foundation of a good-faith estimate of damages.¹⁴

In addition to being negotiated in good faith, a liquidated damages provision must address three elements. First, the amount must be reasonable in light of the anticipated or actual harm caused by the breach.¹⁵ In other words, the sum must be a product of the parties' reasonable estimation of the anticipated loss or the actual loss arising out of a breach addressed in their agreement.¹⁶ The estimate must be reasonable in light of the circumstances of the specific transaction.¹⁷ It should not be either unreasonably large or small in relationship to the anticipated damages.¹⁸ In essence, the amount agreed upon by the parties should not be grossly disproportional to the anticipated or actual damages.¹⁹ However, just what is "grossly disproportional" is a difficult question in most situations, especially in complex commercial transactions between large, sophisticated entities.²⁰

However, courts will uphold a liquidated damages clause commonly used in an industry.²¹ A court will evaluate circumstances at the time of entering into the contract to determine the reasonableness of the liquidated amount in light of the anticipated harm. Additionally, a court may evaluate circumstances at the time of the breach to consider the reasonableness of the liquidated amount in light of the actual harm arising out of the breach to determine if the clause is a penalty.²²

The second necessary element is that the liquidated damages amount must be reasonable in light of the difficulties of establishing a loss in the event of a breach.²³ If actual damages are easily calculable, a liquidated damages clause will not be valid by definition.²⁴ In addition, if the parties stipulate to one liquidated damages amount to be applied to multiple promises of obviously different importance and with different components, the clause will most likely be deemed a penalty.²⁵ The parties should tailor specific amounts in a liquidated damages clause for each type of breach envisioned and decide what would be just compensation for each party under the specific facts.

The third element of a valid liquidated damages clause is that the sum agreed upon by the parties regarding a breach must be reasonable in light of the inconvenience or nonfeasibility of obtaining an adequate remedy.²⁶ However, courts seem to have collapsed this last element into a variation of the second element regarding the difficulty of proof, and it has not received any real focus in court decisions.²⁷



For a seller, a liquidated damages clause can enhance its ability to win important business by signaling its commitment to the buyer and to the transaction.

Caselaw

Courts in Michigan have addressed liquidated damages clauses in a number of situations that help to flesh out what may be considered reasonable between sophisticated businesses. In *UAW-GM Human Resources v KSL Recreation Corp*, the court found valid a liquidated damages clause that fixed cancellation charges with respect to contracted convention services at 65 percent of the revenue for room, food, and beverage totals for the entire stay.²⁸ In *St Paul Fire & Marine Ins Co v Guardian Alarm Co*, the court upheld a liquidated damages clause despite the plaintiff's argument that the clause should not be enforced because damages could have easily been determined by the defendant regularly checking inventory.²⁹

A controversial aspect of liquidated damages clauses is that courts have held that there is no duty to mitigate damages when a contract contains a valid liquidated damages clause.³⁰ With respect to actual damages, courts will conclude that a breaching party is liable for liquidated damages even if the non-breaching party suffered no actual harm, provided that the sum agreed upon in the agreement is reasonable.³¹ Note that even if a liquidated damages clause is found to be void as a penalty, the injured party

can still seek conventional remedies for the breach but will need to prove actual damages.³²

To better understand how courts view liquidated damages clauses, it is prudent to review cases both in Michigan and in other states because commercial enterprises often are involved in deals governed by other state law. When the parties are sophisticated business entities and the damages are economic, courts are reluctant to find that liquidated damages clauses are penalties.³³ One particularly interesting case that highlights this point is *California and Hawaiian Sugar Co v Sun Ship Inc*, in which the non-breaching party suffered \$368,000 in actual damages but the breaching party was forced to pay approximately \$3.3 million in liquidated damages pursuant to the liquidated damages clause.³⁴ In this case, Sun Ship failed to timely deliver a \$25 million barge it was to build. Sun Ship paid liquidated damages of \$17,000 a day and then sued.³⁵

The Court of Appeals for the Ninth Circuit, applying Pennsylvania law, found that the parties had negotiated a reasonable amount in anticipation of the loss of the sugar crop if that crop could not be transported because of a failure to deliver the barge on time. The court, noting that the clause was negotiated by parties with relatively equal bargaining power and with the

assistance of counsel, observed that “litigation has blurred the line between a proper and a penal clause, and the distinction is ‘not an easy one to draw in practice.’”³⁶ However, the court concluded that the clause at issue was not a penalty and that:

[T]he parties normally have a much better sense of what damages can occur. Courts must be reluctant to override their judgment. Where damages are real but difficult to prove, injustice will be done to the injured party if the court substitutes the requirements of judicial proof for the parties’ own informed agreement as to what is a reasonable measure of damages.³⁷

Key Considerations

A key point from this and other cases is that parties must consider carefully what could happen in the breach situation and be comfortable that they have negotiated a reasonable damages amount under the foreseeable circumstances. Parties should analyze fully all the probable circumstances surrounding a potential breach and understand that their estimate of the damages for that breach may differ significantly from the actual loss incurred.

Requiring a liquidated damages clause in significant commercial sales agreements can be a very effective way to enforce business discipline and ensure that an enterprise understands the risks involved. Including a liquidated damages clause will force the individuals negotiating the agreement to consider more than the usual terms such as pricing, quantity, delivery, and quality. They will need to give thought to understanding what circumstances may give rise to a breach and what is a reasonable estimate of the resulting damages.

Moreover, and maybe most importantly, including a liquidated damages clause in important commercial deals can serve to keep senior management aware of potentially significant business risks arising out of business activities if protocol requires that senior management review and approve contract terms governing major deals. Without a liquidated damages clause in major sales contracts, senior management may not fully consider the risks involved in the transaction and the consequences before it is too late and the enterprise is facing serious liability issues and possibly costly litigation. A well-drafted liquidated damages clause may take time, but can yield significant benefits in protecting businesses in a breach situation. ■



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FOOTNOTES

1. *St Clair Medical, PC v Borgiel*, 270 Mich App 260, 270–271; 715 NW2d 914 (Mich App, 2006); see, e.g., Trentacosta, ed, *Michigan Contract Law*, §§10.32–10.39 (ICLE, 1998).
2. *Superior Steel Spring Co v New Era Spring & Specialty Co*, 215 Mich 594; 184 NW 440 (1921).
3. See, e.g., Aiello, *Use of liquidated damage and limitation of remedies clauses in contracts*, 16(1) Mich Bus LJ 11 (1994).
4. See Williston on Contracts (4th ed), §65:6.
5. *Ross v Loescher*, 152 Mich 386; 116 NW 193 (1908).
6. *Tata Consultancy Services v Systems Int’l, Inc*, 31 F3d 416 (CA 6, 1994).
7. *Worley v McCarty*, 354 Mich 599; 93 NW2d 269 (1958).
8. See, e.g., *Latimer v William Mueller & Son, Inc*, 149 Mich App 620; 386 NW2d 618 (1986).
9. *Board of Education of City of Sault Ste Marie v Chaussee*, 211 Mich 61; 177 NW 975 (1920).
10. MCL 440.2302 allows a Michigan court to reject a contract or clause determined to be unconscionable. See Trentacosta, *UCC 2-302 Unconscionability in a commercial setting*, 12(4) Mich Bus LJ 7 (October 1989).
11. *Stenke v Masland Development Co, Inc*, 152 Mich App 562; 394 NW2d 418 (1986); *Roland v McKenzie*, 11 Mich App 604; 162 NW2d 97 (1968).
12. *Allen v Michigan Bell Tel Co*, 18 Mich App 632; 171 NW2d 689 (1969).
13. *Curran v Williams*, 352 Mich 278; 89 NW2d 602 (1958).
14. *Board of Commerce of Ann Arbor, Mich v Security Trust Co*, 225 F 454 (CA 6, 1915).
15. *UAW-GM Human Resources v KSL Recreation Corp*, 228 Mich App 486; 579 NW2d 411 (1998).
16. Official Comment 1 to UCC 2-718 states that liquidated damages clauses are valid when the amount is reasonable in light of the circumstances surrounding the transaction.
17. *St Clair Medical*, n 1 *supra*; *St Paul Fire & Marine Ins Co v Guardian Alarm Co of Michigan*, 115 Mich App 278; 320 NW2d 244 (1982).
18. *Watson v Harrison*, 324 Mich 16; 36 NW 295 (1949); *Jewitt, Bigelow & Brooks v Detroit Edison Co*, 274 F 30 (CA 6, 1921); Official Comment 1 to UCC 2-718 states that an unreasonably small amount may be voided as unconscionable.
19. *St Clair Medical*, n 1 *supra*.
20. *Lake River Corp v Carborundum Co*, 769 F2d 1284 (CA 7, 1985).
21. *Skyline Steel Corp v AJ Dupuis Co*, 648 F Supp 360 (ED Mich, 1986).
22. *Moore v St Clair County*, 120 Mich App 335; 328 NW2d 47 (1982).
23. *Worley v McCarty*, 354 Mich 599; 93 NW2d 269 (1958), *Curran*, n 14 *supra*, and *Wilkinson v Lanterman*, 314 Mich 568; 22 NW2d 827 (1946).
24. *Worley*, n 24 *supra*; *Federal Electric Co v National Service Stations*, 255 Mich 425; 238 NW 174 (1931).
25. *Decker v Pierce*, 191 Mich 64; 157 NW 384 (1916); *Buckhout v Witwer*, 157 Mich 406; 122 NW 184 (1909). But cf. *Ann Arbor Asphalt Construction Co v City of Howell*, 226 Mich 647; 198 NW 195 (1924) (where different breaches result in withholding the same sum upheld).
26. See *Wilkinson*, n 24 *supra*.
27. Aiello, n 3 *supra* at 12.
28. *UAW-GM Human Resources*, n 16 *supra*.
29. *St Paul Fire & Marine*, n 18 *supra*.
30. *Barrie School v Patch*, 401 Md 497; 933 A2d 382 (2007). But cf. Crespi, *Measuring “actual harm” for the purpose of determining the enforceability of liquidated damages clauses*, 41 Hous LR 1579 (2005).
31. *Barrie School*, n 31 *supra* at 515; *Willgohs v Buerman*, 115 NW2d 59, 62 (Minn, 1962).
32. *Lake River Corp*, n 21 *supra*.
33. *Roland v Kenzie*, 11 Mich App 604; 162 NW2d 97 (1968); *Purcell Tire & Rubber Co v Executive Beechcraft, Inc*, 59 SW3d 505 (Mo, 2001).
34. *California and Hawaiian Sugar Co v Sun Ship Inc*, 794 F2d 1433 (1986); cert den 484 US 871 (1987).
35. *Id.* at 1434–1435.
36. *Id.* at 1438, citing *Lake River Corp* n 21 *supra* at 1290.
37. *Id.*