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Drafting and Enforcing Termination Clauses in Commercial Contracts

Maximizing Recovery or Minimizing Loss When Contracts End Due to Breach, Insolvency, Milestone Failure, Expiration or Other Reason

TUESDAY, APRIL 26, 2016

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

Rebekah R. Conroy, Partner, **Brown Moskowitz & Kallen**, Summit, N.J.

Timothy Murray, Partner, **Murray Hogue & Lannis**, Pittsburgh

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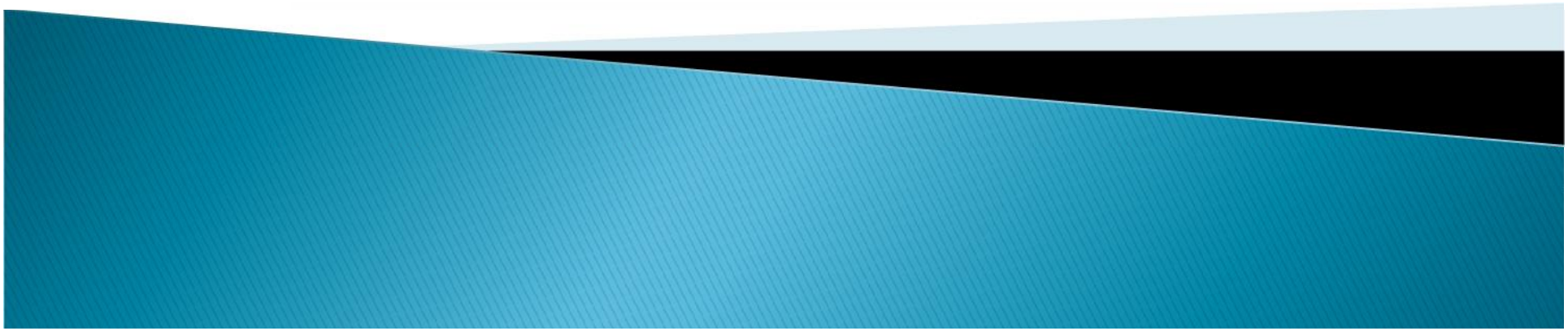
Drafting and Enforcing Termination Clauses in Commercial Contracts

TIMOTHY MURRAY
MURRAY, HOGUE & LANNIS
TMURRAY@MHANDL.COM



Drafting clauses dealing with material breach

- A breach of contract may be "material" or "immaterial."
- When a party to a contract *materially* breaches the contract, the other party is—if it so chooses—discharged and freed of any obligation to perform and may at that point sue for damages.
- When a breach is *immaterial*, the nonbreaching party is *not* excused from future performance and may sue only for the damages caused by the breach.

Material Breach

FACTORS TO DETERMINE MATERIAL BREACH -- *Restatement (Second) Contracts*, § 241):

In determining whether a failure to render or to offer performance is material, the following circumstances are significant:

(a) the extent to which the injured party will be deprived of the benefit which he reasonably expected;

(b) the extent to which the injured party can be adequately compensated for the part of that benefit of which he will be deprived;

Material Breach

Restatement (Second) Contracts, § 241 (continued):

(c) the extent to which the party failing to perform or to offer to perform will suffer forfeiture;

(d) the likelihood that the party failing to perform or to offer to perform will cure his failure, taking account of all the circumstances including any reasonable assurances;

(e) the extent to which the behavior of the party failing to perform or to offer to perform comports with standards of good faith and fair dealing.

Material Breach

- A problem with relying on a court to decide whether a breach was material: without a court order, you can't know for certain if the breach was material or if you have the right to be discharged from your contractual obligations.
  - Example: *Kodak Graphic Communs. Can. Co. v. E. I. du Pont de Nemours & Co.*, 2016 U.S. App. LEXIS 1764 (2d Cir. N.Y. 2016)(whether late delivery of order was a material breach was a fact question despite presence of "time is of the essence" clause).

Drafting clauses dealing with material breach

- The contract can avoid the uncertainty as to what constitutes a "material breach" by *spelling out the events* that warrant termination.
- Even non-material events can be included as events warranting termination—*e.g.*, "any violation of a an employee handbook that is not cured within 10 days following notice."

Example: Provision spelling out events warranting termination

- The following warrant immediate termination of this Agreement: any violation of this Agreement or the employee handbook that is not cured within ten days of written notice [*etc.--list other events*] in addition to any and all other reasons, regardless of their dissimilarity to the foregoing, deemed to warrant termination under the law. A termination in accordance with this paragraph shall not be the Employer's sole and exclusive remedy for any breach of this Agreement.

Drafting clauses dealing with material breach

- Cautionary notes about drafting clauses that allow termination:
  - *Expressio unius est exclusio alterius* would exclude any item not specifically listed.
  - The solution: add a catch-all—but this needs to deal with *ejusdem generis* by referencing *dissimilar* events or circumstances.
  - Note that it is (or is not) the sole and exclusive remedy.

“Ipso Facto Clauses”

- This Agreement shall terminate, without notice (i) upon the institution by or against either party of insolvency, receivership or bankruptcy proceedings or any other proceedings for the settlement of either party's debts, (ii) upon either party making an assignment for the benefit of creditors, or (iii) upon either party's dissolution or ceasing to do business.

"Ipso Facto" Clauses

- Provisions that purport to allow a party to terminate an executory contract (an agreement that the parties have not fully performed) in the event the other party is subject to a voluntary or involuntary filing of bankruptcy, insolvency, or a general assignment for the benefit of creditors.
- These clauses generally are unenforceable in the event a bankruptcy case is filed. (11USC § 365(c) and (e)(1)).

"Ipso Facto Clauses"

- Why include them in a contract?
  - Not all insolvencies end up in bankruptcy.
  - An *ipso facto* clause is not invalid if "applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to the trustee or to an assignee of such contract or lease, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties …."

“Ipso Facto Clauses”

- Some common exceptions:
  - Personal services contracts (example: music recording contract; contract requiring debtor to paint a mural). Also, depending on the jurisdiction: partnership agreements, intellectual property licenses, government contracts, franchise agreements, and limited liability company agreements.
  - Contracts “to make a loan, or extend other debt financing or financial accommodations, to or for the benefit of the debtor, or to issue a security of the debtor."

Failure to reach contractual milestone

- The contract can establish milestones for the performance of obligations.
- For milestones where it is critical that performance be timely, the contract should state that "time is of the essence."
  - "Time is of the essence" can turn delay into material breach.
  - Use "time is of the essence" only when necessary.
  - Put the language immediately next to the milestone–avoid a generalized "time is of the essence cause.

Failure to reach contractual milestone

- For milestones that are missed, the contract can establish a penalty system depending on the importance of the deadline and the degree of tardiness:
  - One possibility: liquidated damages—but make sure it is not a disguised penalty:

    (1) The stipulated amount must be reasonable in light of the anticipated or actual (the modern rule) loss caused by the breach; and

    (2) actual damages would be difficult to estimate in advance or to prove after a breach occurs.

Contract Expiration

Difference in terminology:

- "Termination"—when a party puts an end to the contract otherwise than for its breach.
- "Cancellation"—when either party puts an end to the contract for breach.
- "Expiration"—when a contract's term is up or it ends automatically according to its terms.

How a contract expires

- If the contract states a definite term, it automatically ends at the conclusion of the term.
- If the contract states no term or duration:
  - If the contract references a specific event that would signal its end, it ends automatically when that event occurs.
  - If the contract references no event to signal its end, it ends within a reasonable time (and it is terminable at will).

What happens when the parties ignore a contract's expiration?

- When a contract expires by its own terms, if the parties continue to perform as if under it, the law deems their performance to be a contract implied-in-fact (which is an express contract) on the same terms and conditions as the original contract.

Drafting considerations for contract expiration

- *Best practice*: spell out a definite term (to allow the contract to end in a "reasonable time" is a recipe for litigation).
- The time to consider what needs to occur following expiration is the drafting stage.
  - Does anything need to be done at the expiration (tools returned? Site cleaned up/hazards removed? Return or destruction of confidential information?) If so—spell it out.
- Survival clause?
- Post-expiration restrictive covenant?

Drafting expiration clauses

- Term. The Term of this Contract will be for five (5) years beginning on the Effective Date.
- "The contractor shall [*promptly/immediately/within 5 or some other number of days*] vacate the premises and return to the owner all property and equipment belonging to, or furnished or paid for by the owner."

Drafting expiration clauses

- "At the disclosing party's request, all confidential information, whether in written form, electronically stored or otherwise, and all copies thereof, that is in the possession of the receiving party, including its agents, employees, subcontractors, or representatives, shall [*promptly/immediately/within 5 or some other number of days*] be returned to the disclosing party, or destroyed. If so requested by the disclosing party, the receiving party shall deliver to the disclosing party a certificate executed by one of its duly authorized officers confirming compliance with the obligation to return or destroy all such information."

Drafting Expiration Clauses

- "The contractor shall take all necessary action to protect and preserve the property, to clean up the site, to remove hazards, and to take all other action necessary to leave a safe and healthful site. After those obligations have been accomplished, the contractor shall immediately vacate the site and return all means of access to the site (keys, etc.) to the owner."

Evergreen Clause

- *Consider the potential benefits of an evergreen clause*: "The contract will automatically renew at each fifth anniversary for an additional five (5) year term unless terminated by either party by giving written notice to the other party at least ninety (90) days, but no more than one hundred twenty 120 days, prior to the end of the then-current five (5) year term."

Drafting expiration clauses

- Evergreen Clauses:
  - A contractual provision that provides for the automatic renewal of the contract at the conclusion of its initial term absent notice in advance of an intention not to renew is often referred to as an “evergreen” provision.
  - Late notice pursuant to an automatic renewal provision in a contract is ineffective.

Evergreen clause problems

- Evergreen clauses can create thorny administrative problems by requiring the client to furnish notice within a notice period that is often narrow. It is a common error to accidentally miss the deadline.
- If the clause requires notice to terminate considerably in advance of the automatic renewal date, the client may lack sufficient meaningful information about the value of the contract or the efficacy of its provisions to make an informed decision as to whether to renew or to terminate.
- Some legislatures require evergreen provisions to be conspicuous, and that the vendor remind the customer that he or she must comply with the “evergreen” provision.

Termination for convenience

- A termination for convenience clause allows a party to terminate without cause, *i.e.*, notwithstanding the absence of any breach or fault by the other party.
  - A provision requiring written notice prevents the promise made by the party with the right of termination from being regarded as illusory in nature

Termination for convenience

- *Example*: "[Client] may terminate this agreement for any reason by giving the Vendor at least 30 days' prior notice."

NAVIGATING THE TERMINATION PROCESS

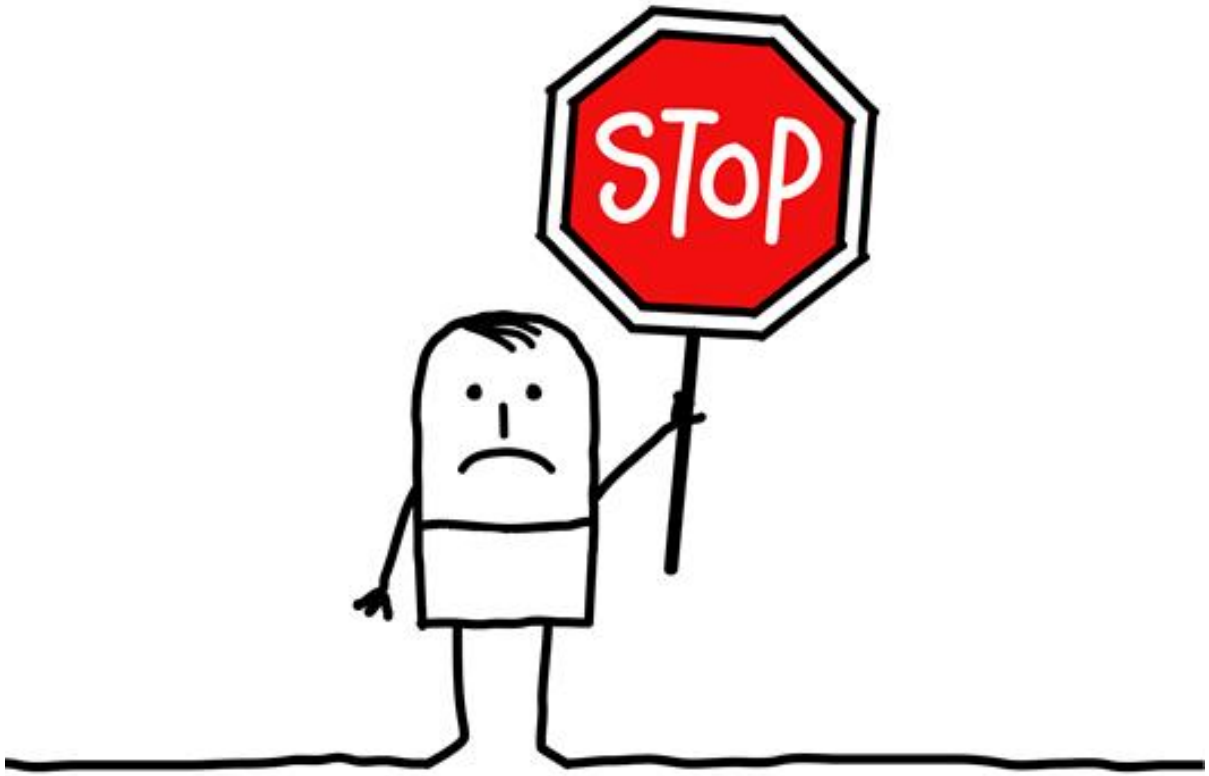
REBEKAH R. CONROY
PARTNER
BROWN MOSKOWITZ & KALLEN, P.C.
973-376-0909
RCONROY@BMK-LAW.COM

Follow the Contract

Follow the Contract

- The most critical undertaking in any termination process is to follow the express language of the underlying contract. The contract should guide you through each:
  - Notice of Termination
  - Opportunity to cure default
  - Contractual provisions, rights and obligations that survive termination
  - Duties and obligations of parties that arise from termination

Notice of Termination



Notice of Termination

- Check the contract—is there a specific way notice must be given?
  - A fight on the phone, ending with "You're fired!" or "we'll never do business together again!" is unlikely to suffice.

➢ Even before termination –does the agreement call for good faith discussion of disputes prior to termination?

Notice of Termination

- Be as specific as possible.
  - If you are terminating pursuant to a clause in the contract, cite the specific clause.
  - State when the termination is effective.
    - Immediate?
      - OR
    - Notice period?

- State the details of why you are terminating
  - Breach be defaulting party?
  - Non-conforming goods?
  - Key dates
  - Recite prior attempts to cure problems, or prior problems

Notice of Termination

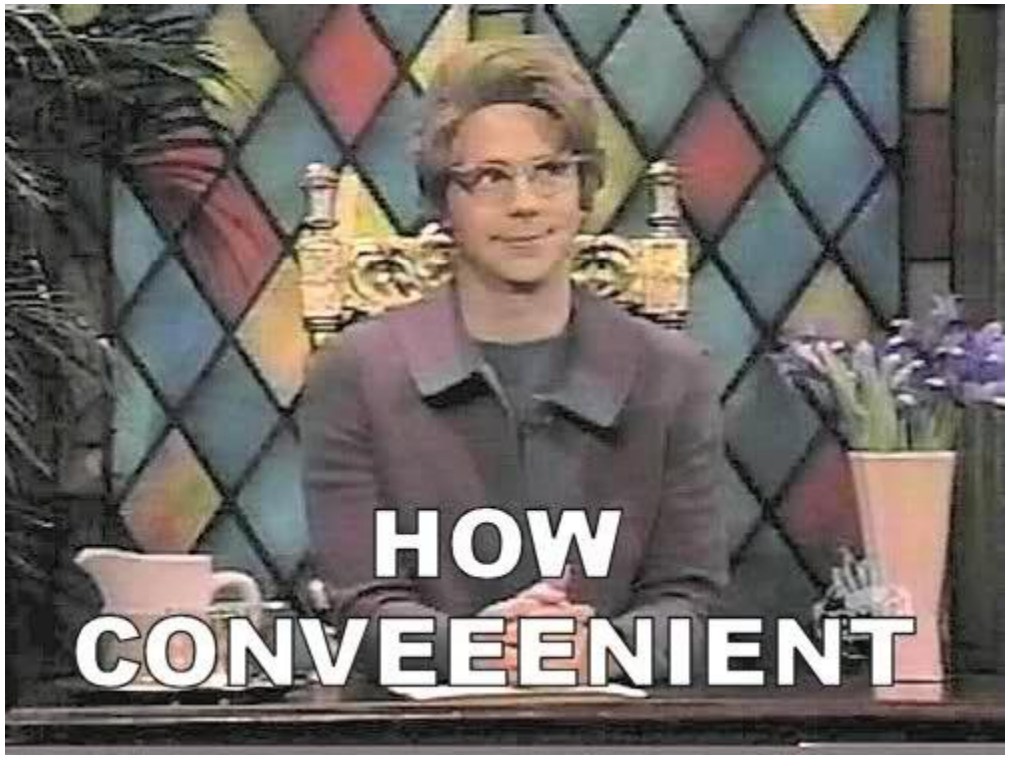
- Describe anticipated breaches by the defaulting party as well
  - A statement by the breaching party that he will not comply in the future
  - Here is where angry statements can server your needs:
    - “You advised that you would never comply with the specified delivery dates and angrily hung up the phone on me.”

Notice of Termination

- Don't be lazy
  - If the contract calls for all notices to be sent to 10 people—sending it to 9 will not suffice
  - If the contract calls for all notices to be served via Certified Mail, e-mail will not suffice
  - Do not rely on a telephone call or in-person meeting
  - WRITE IT DOWN AND SEND IT OUT

Notice of Termination

- Termination for Convenience



Notice of Termination

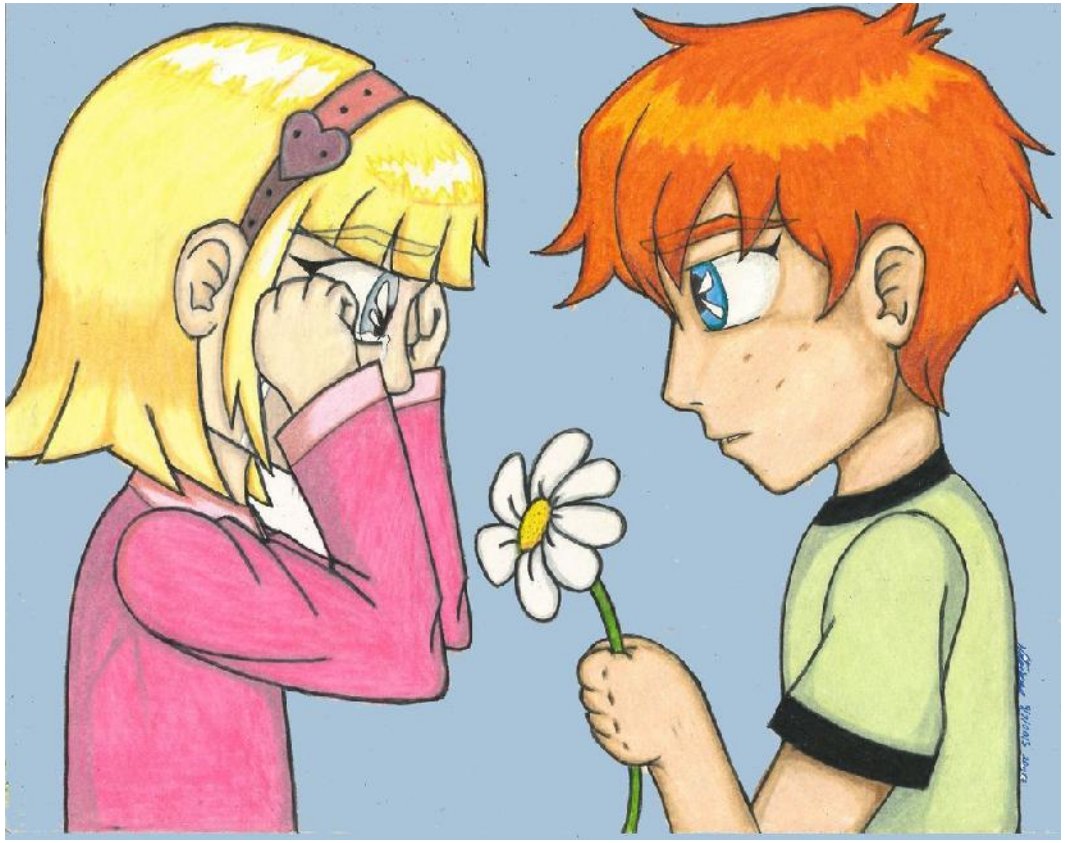
- **Termination for convenience**
- In an "at will" business agreement, parties can agree to termination, even in the absence of fault or breach, without suffering the usual financial consequences.
  - Near *carte blanche power*

➢Obligation of good faith and fair dealing applies.

Notice of Termination

- **Termination for convenience contd.**
- UCC Section 2-309—
  - Contracts of indefinite duration are terminable at will by either party, even if not expressly set forth in the agreement.
  - If the party is terminable at will, any reason will do, so long as there is "reasonable" advance notification

Opportunity to Cure Default



Opportunity to Cure Default

1. Review the contract!

1. Absent a contractual clause
   1. Equities at play
   2. Need to provide opportunity to cure

Special Circumstances:

- Repossess property
- Futility of Opportunity to Cure
- Mitigation of Damages

Contractual Provisions, Rights, and Obligations that Survive Termination

Contractual Provisions, Rights, and Obligations that Survive Termination

- Read the Contract!
- Certain clauses you may want to survive include:
  - Protection of confidential information/ non-disclosures
  - Non-Compete Clauses
  - Indemnification
  - Tax Matters
  - Environmental
  - Earned pay/bonuses/commission
  - Limitation of liability

Contractual Provisions, Rights, and Obligations that Survive Termination

- Some terms may shift at termination, particularly where there will be a transition period to a new agreement
  - For example, a music publishing company that charges 15% royalties for the duration of the agreement, may charge 10% post-termination, until the artist designates a new publishing company.

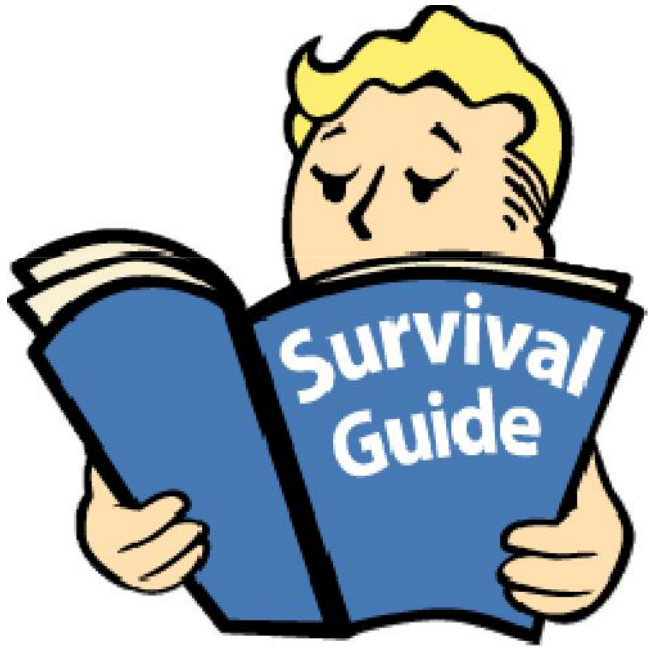
Contractual Provisions, Rights, and Obligations that Survive Termination

- If you are drafting the agreement, be sure to consider what rights your client will want to maintain after termination.
  - Expenses incurred post-termination (i.e., transfer costs)
  - Lag time costs/delay
  - Delivery of all previously placed orders on the same terms as when placed

Contractual Provisions, Rights, and Obligations that Survive Termination

- Litigation provisions
  - Choice of Law
  - Choice of Forum
  - Attorney's Fees
  - Compliance with Laws
  - Insurance Provisions

Duties and Obligations that Arise from Termination



Duties and Obligations that Arise from Termination

- Read the Contract!

- Post-Termination Obligations--examples
  - Purge of Confidential Information vs. Retain Confidential Information
  - Non-Compete
  - Non-Solicitation
  - Non-poaching

Duties and Obligations that Arise from Termination

- Special Circumstances
  - Franchise Agreements
    - De-Branding/Re-Branding
    - Customer Lists
    - Ownership of Phone Numbers
    - R&D Collaboration—ownership of data and research
    - Employment Agreements
    - Bad Faith
    - ❑Bonuses accrued pre-termination
    - ❑Vacation Days
    - ❑Insurance

Duties and Obligations that Arise from Termination

- UCC2-106- “On "termination" all obligations which are still executory on both sides are discharged but any right based on prior breach or performance survives.”

Duties and Obligations that Arise from Termination

- Other Considerations
  - Liquidated Damages
  - Duty of Fidelity
  - Fiduciary Duty
  - Dispute Resolution
  - Antitrust Considerations
  - Duty of Good Faith and Fair Dealing

Post-Termination Remedies: Limitations and Enforcement Challenges

REBEKAH R. CONROY
PARTNER
BROWN MOSKOWITZ & KALLEN, P.C.
973-376-0909

Limitations on Enforcement

- Unconscionability
  - General escape clause for patently unfair clauses

Clauses More Likely to be Subject to Challenge

1. Covenant not to compete
2. Liquidated Damages Clauses
3. Proprietary Information
4. Restraint on Trade/Monopoly

Covenant not to Compete

- Covenant not to Compete- example:
  - under the terms of any employment contract or otherwise, and for one (1) year thereafter, EMPLOYEE will not directly or indirectly, own, manage, operate, join, control, or participate in the ownership, management, operation or control of, or be employed by or connected in any manner with, any business engaged anywhere in the world in the athletic footwear business, athletic apparel business, or any other business which directly competes with Shoes Corp. or any of its subsidiaries or affiliated corporations.

Covenant not to Compete

- Covenant not to Compete- Limitations:
  - Generally enforceable, however, various states have put some limits on what types of clauses will be reasonable:
    - Limited in duration (cannot forever ban an individual from participating in an industry)
  - Must have been given in exchange for valid consideration
  - Must be limited in terms of scope (geographic and practical implications)

Covenant not to Compete

- Limitations:
  - Cannot prevent employee from earning a living
  - Cannot extract a pound of flesh
  - Limitations by jurisdiction—some interesting restrictions:
    - NJ- cannot ask employee to "shut his eyes" to what was learned on the job
    - NY- the clause cannot be "injurious to the public"
    - Utah- unenforceable if designed only to protect the employer's interests

Covenant not to Compete

- Limitations, contd.
  - Courts may "blue pencil" a covenant not to compete that has gone too far
  - Insufficient consideration
    - Continuation of employment (Washington State)
    - Franchise Agreements
    - In writing
    - By profession
    - Undue Hardship
    - Public Interest

Liquidated Damages

Enforceability of Liquidated Damages Clauses

- Reasonableness of Clause at Time of Contract and at Time of Breach
- Difficulty Calculating Actual Damages
- Avoiding Perception of Liquidated Damages Clause as Penalty

Reasonableness at Time of Contract vs. Time of Breach

Reasonable at Time of Contract vs. Time of Breach

"**The time as of which the forecast of loss must be judged to be reasonable has traditionally been regarded as the time when the contract was made, not the time when the breach occurred.**" E. ALLAN FARNSWORTH, CONTRACTS § 12.18 , note 5, at 301-02 (2d ed. 1998).

"**[T]he modern trend is towards assessing reasonableness either at the time of contract formation or at the time of the breach.**" *Wasserman's Inc. v. Middletown*, 645 A. 2d 100 (N.J. 1994)

The New Jersey Supreme Court offered the following observation in adopting the retrospective approach: "**Determining enforceability at the time either when the contract is made or when it is breached encourages more frequent enforcement of stipulated damages clauses.**" *Wasserman's*, 137 N.J. at 252.

Reasonable at Time of Contract vs. Time of Breach

"It is not the function of the court to determine by hindsight the reasonableness of the expectation of the parties at the time the contract was made, but it is the function of the court at the time of enforcement to do justice. In the ordinary contract action the court determines the just damages from evidence offered. In a valid contract for liquidated damages, the parties are permitted, in order to avoid the uncertainties and time-consuming effort involved, to estimate in advance the reasonably probable foreseeable damages which would arise in the event of a default. Implicit in the transaction is the premise that the sum agreed upon will be within the fair range of those just damages which would be called for and provable had the parties resorted to proof. Consequently, if the damage envisioned by the parties never occurs, the whole premise for their agreed estimate vanishes, and, even if the contract was to be construed as one for liquidated damages rather than one for a penalty, neither justice nor the intent of the parties is served by enforcement. To enforce it would amount in reality to the infliction of a penalty."

Norwalk Door Closer Co. v Eagle Lock & Screw Co., 220 A2d 263 (Conn. 1966)

Reasonable at Time of Breach

Reasonable at Time of Breach

Twenty courts permit a "second look," which takes into account consideration of actual damages flowing from a breach:

- **Texas** (*Thanksgiving Tower Partners v. Anros Thanksgiving Partners*, 64 F.3d 227, 232 (5th Cir. 1995));
- **Illinois** (*Yockey v. Horn,* 880 F.2d 945, 952-953 (7th Cir. 1989))
- **Alabama** (*Southpace Properties, Inc. v. Acquisition Group*, 5 F.3d 500, 505 (11th Cir 1993))
- **Hawaii** *Ventura v. Grace*, 3 Haw. App. 371, 374 (1982)
- **Idaho** *McEnroe v. Morgan*, 106 326, 331-332 (1984))
- **Iowa** (*Rohlin Constr. Co. v. Hinton*, 476 N.W.2d 78, 80 (1991))
- **Kentucky** *Mattingly Bridge Co.* v. Holloway & Son Constr. Co., 694 S.W.2d 702, 705 (Ky. 1985))
- **Missouri** *(Hawkins v. Foster*, 897 S.W.2d 80, 85 (**Mo.** Ct. App. 1995))
- **Montana** (*Weber v. Rivera*, 255 Mont. 195, 200 (1992));
- **Nebraska** (Kozlik v. Emelco, Inc., 240 Neb. 525, 536-537 (1992))
- ***Nevada*** (*Mason v. Fakhimi*, 109 Nev. 1153, 1156-1157 (1993))
- **New Hampshire** *(Shallow Brook Assocs. v. Dube*, 135 N.H. 40, 48-49 (1991))
- **New Jersey** (*Wasserman's Inc. v. Middletown*, 137 N.J. 238, 251 (1994))
- **North Carolina** (*Knutton v. Cofield*, 273 N.C. 355, 361 (1968))
- **Ohio** (Lake Ridge Academy v. Carney, 66 Ohio St. 3d 376, 382 (1993))
- **Oregon** (*Illingworth v. Bushong*, 297 Or. 675, 693 (1984))
- **Tennessee** (*Crews v. Dexter Rd. Partners*, Court of Appeals of Tennessee No. 02A01-9603-CH-00045 (Jan. 28, 1998))
- **West Virginia** (*Wheeling Clinic v. Van Pelt*, 192 W. Va. 620, 626 (1994))
- **Wisconsin** (*Koenings v. Joseph Schlitz Brewing Co.*, 126 Wis. 2d 349, 363 (1985))
- **Wyoming** (*Jessen v. Jessen*, 810 P.2d 987, 990 (Wyo. 1991).

* List taken from *Kelly v. Marx*, 44 Mass. App. Ct. 825 (1998), *rev'd* 428 Mass. 877 (1999).

Reasonable at Time of Breach

What basis is there for calculating whether the clause is reasonable at the time of the breach?

- *Corbin on Contracts* notes that what actually occurs matters—courts have refused to enforce liquidated damages clauses on the "express ground that the actual injury done was either nothing at all or was not hard to determine and was very much less than the agreed sum." 5 *Corbin on Contracts* § 1063 at 365 (1964 and Supp. 1996 at 149-50).

- *Restatement (Second) of Contracts,* § 356, cmt. b at 158. "If, to take an extreme case, it is clear that no loss at all has occurred, a provision fixing a substantial sum as damages is unenforceable."

- *Hindsight is better than foresight*:

  - "Actual damages, moreover, reflect on the reasonableness of the parties' prediction of damages. 'If the damages provided for in the contract are grossly disproportionate to the actual harm sustained, the courts usually conclude that the parties' original expectations were unreasonable.' *Wassenar v. Panos*, 331 N.W.2d 518 (Wisc. 1983); see 5A. *Corbin on Contracts* § 1063 (1951) ('It is to be observed that hindsight is frequently better than foresight, and that, in passing judgment upon the honesty and genuineness of the pre-estimate made by the parties, the court cannot help but be influenced by its knowledge of subsequent events.')."
    - *Nohe v. Roblyn Development Corp.*, 296 NJ Super. 172 , 176 (N.J. App. Div. 1997)

Cases finding Reasonable at Time of Breach

- **Lake Ridge Academy v. Carney, 66 Ohio St. 3d 376 (Ohio 1993)** – explaining that in weighing challenges to liquidated damages clause "the court must step back and examine it in light of what the parties knew at the time the contract was formed and in light of an estimate of the actual damages caused by the breach. If the provision was reasonable at the time of formation and it bears a reasonable (not necessarily exact) relation to actual damages, the provision will be enforced. "

- **Yockey v. Horn, 880 F. 2d 945 (7th Cir. 1989)**—enforcing $50,000 liquidated damages clause for breach of settlement agreement, explaining "reasonableness of the amount set in a liquidated damages clause is to be looked at as of the time of contracting and at the time of actual breach. If at either time the estimate is reasonable, the clause will be enforced."

- **McEnroe v. Morgan, 678 P. 2d 595 (Idaho 1984)**—instructing trial court "to weigh the amount of actual damages suffered by the vendor because of the breach against the amount of liquidated damages to determine whether the latter amounts to a penalty," and upholding liquidated damages clause where actual damages were at least seventy-eight percent of the liquidated damages .

- **Rohlin Const. Co. v. City of Hinton, 476 NW 2d 78 (Iowa 1991)**—finding no valid justification for $400/day liquidated damages associated with delayed highway project where "no witness was called to justify the suggested liquidated damage amounts contained in the DOT manual schedule. The county engineer did not conduct studies or present any other data suggesting that defendants anticipated that the government entities and the public could sustain damages equivalent to the $400-per-day liquidated damage amount contained in each of the three contracts."

Reasonable at Time of Contract

Reasonable at Time of Contract

"The parties, at the time the agreement was entered into, considered many factors affecting damages, namely: the uncertainty of the plaintiff's ability to re-rent the said vehicles; the plaintiff's investment in purchasing and reconditioning the vehicles to suit the defendant's particular purpose; the number of man hours not utilized in the non-service of the vehicles in the event of a breach; the uncertainty of reselling the vehicles in question; the uncertainty of the plaintiff's savings or expenditures for gasoline, oil or other service items, and the amount of fluctuating interest on the bank loan."

Truck Rent-A-Ctr. v. Puritan, 41 NY 2d 420, 423 (1977)

Reasonable at Time of Contract

Carrothers Const. Co., L.L.C. v. City of South Hutchinson, 207 P.3d 231, 242-43 (Kan. 2009) (embracing a single-look prospective analysis as the sole basis for evaluating liquidated damages)

Kelley v. Marx, 705 N.E.2d 1114 (Mass. 1999)

(rejecting a second-look approach that includes actual damages, and instead, focusing on the forecast at the time of contracting).

Kernz v. J.L. French Corp., 667 N.W.2d 751 (Wis. Ct. App. 2003)

(evaluating the harm anticipated at the time of contract formation and the actual harm at the time of breach to determine reasonableness of forecast)

Orr v. Goodwin, 953 A.2d 1190 (N.H. 2008)

(applying a prospective-retrospective, two-pronged approach to evaluate if actual damages are easily ascertainable and grossly disproportionate to the stipulated damages).

Reasonable at Time of Contract

Of course, "[r]easonableness is the touchstone" is the key when determining whether a liquidated damages clause is enforceable."

Rajski v. Tezich, 514 N.E.2d 347 (Ind.App. 1987).

As the Tennessee Supreme Court explained:

> The retrospective approach, however, undermines the certainty and other benefits afforded by liquidated damages. Under that approach, the parties are allowed to fully litigate actual damages following a breach of contract. If the nonbreaching party fails to prove actual damages, then he or she is barred from recovering the liquidated sum originally agreed upon in the contract. We find that it is unfair to require the nonbreaching party to prove actual damages in cases where the parties agreed in advance to a liquidated damages provision. Such a requirement ignores the original intentions of the parties and defeats the purposes of stipulating in advance to potential damages.

Guiliano v. Cleo, Inc., 995 SW 2d 88, 100 (Tenn. 1999)

Reasonable at Time of Contract

Twenty-two courts appear to apply the "single look" approach by limiting evaluation of the reasonableness of a liquidated damages provision to the time of contract formation:

Washington, D.C. ((Barnette v. Sayers, 289 F. 567, 570 (D.C. Cir. 1923))

New York (*New York Rattigan* v. *Commodore Intl. Ltd.,* 739 F. Supp. 167, 169 (S.D.N.Y. 1990))

Puerto Rico (Tardanico v. Murphy, 983 F. Supp. 303, 309 (D.P.R. 1997)

Alaska (*Alaska Williwaw Lodge v. Locke,* 601 P.2d 236, 239 (Alaska 1979))

Arkansas (*Alley* v. *Rogers,* 269 Ark. 262, 264 (1980))

Colorado (*Rohauer*v. *Little,* 736 P.2d 403, 410 (Colo. 1987))

Connecticut *Hanson Dev. Co. v. East Great Plains Atl. Corp. Ctr., Inc.,* 195 Conn. 60, 65 (1985))

Delaware (*Brazen* v. *Bell Atl. Corp.,* 695 A.2d 43, 48 (Del. 1997))

Florida (*LeFemine* v. *Baron,* 573 So. 2d 326, 328 (Fla. 1991))

Georgia (*Fickling & Walker Co. v. Giddens Constr. Co.,* 258 Ga. 891, 897-898 (1989))

Indiana (*Czeck* v. *Van Helsand,* 143 Ind. App. 460, 463 (1968))

Maryland (*Anne Arundel County* v. *Norair Engr. Corp.,* 275 Md. 480, 494 (1975))

Michigan (*Roland* v. *Kenzie,* 11 Mich. App. 604, 612 (1968))

Minnesota (*Frank* v. *Jansen,* 303 Minn. 86, 91 (1975))

Mississippi (*Trustees of State Insts. of Higher Learning* v. *Johnson,* 507 So. 2d 887, 890 (Miss. 1987))

New Mexico (*Gruschus* v. *C.R. Davis Contr. Co.,* 75 N.M. 649, 655 (1965))

North Dakota (*Fisher v. Schmeling*, 520 N.W.2d 820, 822 (N.D. 1994))

Pennsylvania (*Olmo* v. *Matos,* 439 Pa. Super. 1, 8 (1994))

South Dakota *Safari, Inc. v. Verdoorn,* 446 N.W.2d 44, 46 (S.D. 1989))

Utah *Woodhaven Apartments v. Washington,* 942 P.2d 918, 921 (Utah 1997)

Virginia (*Brooks* v. *Bankson,* 248 Va. 197, 208 (1994))

Washington (*Watson* v. *Ingram,* 124 Wash. 2d 845, 851-853 (1994)).

* List taken from *Kelly v. Marx*, 44 Mass. App. Ct. 825 (1998), *rev'd* 428 Mass. 877 (1999).

Cases Finding Liquidated Damages Clause Reasonable at Time of Contract:

- **Woodhaven Apartments v. Washington, 942 P.2d 918 (Utah 1997)**—finding liquidated damages clause in residential lease agreement unenforceable because of insufficient evidence at time of contract as to time and costs reasonably to be anticipated in an early departure of tenant, as well as to the relationship of these expenses to the termination fee.

- **United States v. Bethlehem Steel Co., 205 U.S. 105 (1907)**—interpreting parties' intentions at time of contract, including Government's preparations for expected war with Spain; finding liquidated damages clause enforceable even where "The fact that not very long after the contract had been signed and the war with Spain was near its end, the importance of time as an element largely disappeared, and that practically no damage accrued to the Government on account of the failure of the company to deliver, cannot affect the meaning of this clause as used in the contract nor render its language substantially worthless for any purpose of security for the proper performance of the contract as to time of delivery."

Cases Finding Liquidated Damages Clause Reasonable at Time of Contract:

- **Guiliano v. Cleo, 995 S.W.2d (Tenn. 1999)**- upholding liquidated damages clause in employment agreement where neither party knew at time of agreement, whether employee would be able to secure employment if terminated without cause

- **Brazen v. Bell Atlantic Corp., 695 A.2d 43 (Del. 1997**)—upholding $550 million termination fee in merger agreement as a valid liquidated damages provision; noting that at the time of the agreement, parties took into account the losses each would have suffered as a result of focusing singularly on pending deal and specifically considered the size of termination fees in other merger agreements found reasonable by Delaware courts, and the lengthy period during which the parties would be subject to restrictive covenants under the merger agreement while regulatory approvals were sought.

Difficulty Calculating Actual Damages

Difficulty Calculating Actual Damages

- Contract should recite difficulty in calculating actual damages
- Contract should recite method(s) utilized to determine liquidated damages amount.
  - Example: **Carrothers Constr. Co., LLC v. City of South Hutchison, 207 P.3d 231 (KS 2009)**—Carrothers was to construct a $5.6M water treatment plant. The contract contained a liquidated damages clause of $850/day the project was delayed. In determining the $850 figure, the City hired City hired an engineering firm that based the rate on several factors, including "cost to monitor the project, additional labor costs, additional use of utilities, the cost of engaging another consultant, legal expenses, equipment rental, possible action by the Kansas Department of Health and Environment, and other unknowns in the event the project was not completed on time."
  - Is it truly difficult to calculate actual damages? Parties should discuss options for forecasting damages—it may be that discussions lead to reasonable forecasts, which may be stumbling block for liquidated damages.
    - Or, discussions may show damages are impossible to forecast with any certainty.

Difficulty Calculating Actual Damages

- Bear in mind who may be the cause of any actual damages incurred:
  - *Wayne Knorr, Inc. v. Dep't of Transp.,* 973 A.2d 1061, 1091-92 (Pa. 2009) ("It is particularly well settled that a party may not retain liquidated damages for the amount of delay caused by its own actions.").
  - In a commercial lease:
    - "[I]f the tenant is an "anchor," or otherwise a primary or significant tenant in the landlord's development or other scheme of operations, it is almost black-letter law that breach by the tenant will result in damages that are uncertain or incapable of accurate calculation: When an anchor tenant ceases operation, the landlord and other tenants suffer even though the anchor tenant continues to pay the base rental. Moreover, the possibility of calculating damages appears difficult, since future percentages and the effect of non-operation on neighboring tenants are such indefinite factors."
      - *Enforceability of Liquidated Damages Clause In Commercial Lease*, 22 Am. Jur. Proof of Facts 3d 137 (1993), citing, Powell*, 2 Powell on Real Property*, ¶257(3)(b)(ii) (1988), cited at *W & G Seaford Associates, L.P. v Eastern Shore Markets, Inc*. (1989, DC Del) 714 F Supp 1336, 1347.

Avoiding Perception of Liquidated Damages Clause as Penalty

Avoiding Perception of Penalty

- Recitals in Contract
  - Damages cannot be reasonably calculated
    - Show why
    - Detail Efforts—discuss what is known and what is unknown
    - Discuss complications
    - Acknowledge parties' mutual agreement
  - Liquidated Damages should bear some proportional relationship to contract's total value

Avoiding Perception of Penalty

- No windfall or double collecting
- In construction cases, apportion damages based on whose "fault" caused the delay.
- "[C]alling an outrageous penalty by the more kindly name of liquidated damages does not absolve it from its sin."
  - A. Corbin, *The Right of a Defaulting Vendee to the Restitution of Installments Paid*, 40 Yale L.J. 1013, 1016 (1931).


THE END
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