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Liquidated Damages Provisions: Best Practices & Key Considerations

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I. Introduction

Liquidated damages provisions are important clauses for franchisors and franchisees to keep in mind when negotiating franchise agreements and when they find themselves in a dispute. Whether or not a liquidated damages provision is ultimately included may change and impact a party's decision-making process under the franchise agreement with respect to many important considerations, such as whether and when to terminate the agreement or cease doing business, and the damages that would result from those decisions.

This paper provides a greater understanding of liquidated damages provisions and their use in franchise agreements. Section II explores what liquidated damages are with a quick historical analysis of its origins, followed by an examination of current prevailing law. Section III examines the Restatement (Second) of Contract's approach to liquidated damages. Section IV discusses the benefits associated with liquidated damages provisions, with a particular focus on the resulting efficiency and predictability they add to the agreement, as well as their involvement in assisting with the early resolution of disputes. Section V shifts the discussion towards understanding the necessary elements that must be present to enforce a liquidated damages provision. Section VI provides tips on how to best draft a liquidated damages provision, including examples of well-drafted and poorly drafted provisions, and particular things to consider, including state law differences. Section VII evaluates ways in which a party may successfully defend against the enforcement of liquidated damages provisions.

II. What Are Liquidated Damages?

Black's Law Dictionary defines "liquidated damages" as "cash compensation, agreed to by a signed, written contract for breach of contract, payable to the aggrieved party." When parties to a franchise agreement include a liquidated damages provision in their contract, they are agreeing upfront to a certain computation of potential damages before a breach of the contract ever occurs.

The fundamental purpose of a liquidated damages provision is to provide a reasonable measure of compensation in the event a breach occurs where, at the time the provision is agreed to, the damages are indeterminable or will be otherwise difficult to prove.[1] Put another way, "a liquidated damages clause in a contract is an advance settlement of the anticipated actual damages arising from a future breach. It allows contracting parties to protect themselves against the difficulty, uncertainty, and expenses involved when trying to ascertain actual damages."[2]

Early English legal history forms the basis of liquidated damages and the defenses that are available to attack them. The application of liquidated damages in law

[1] Williston on Contracts, § 65:3 (4th Ed.)

[2] *Gator Apple, LLC v. App. Tex. Rests., Inc.*, 442 S.W. 3d 521, 535 (Ct. App. Tex. 2014).

developed as a reaction to the harshness of penal bonds—a form of assurance whereby an individual would bind himself to pay a definite sum of money in the event he failed to perform another primary obligation.[3] If a party breached the agreement, the entire amount of the bond was due immediately, without any consideration of actual damage suffered.[4] Parties in breach of contractual obligations were being unfairly penalized and forced to pay disproportionate sums of money to the non-breaching party, even in circumstances where the non-breaching party suffered no damages as a result of the breach.[5] As jurisprudence in this area of law continued to evolve, courts began to grant relief against these harsh penal bonds, finding that stipulated penalties are void and unenforceable as a matter of law.[6]

American courts realized that in certain situations where the actual damages could not be readily ascertained, promises to pay a stipulated sum in the event of a breach of contract were a valid alternative to the uncertainty of a jury's award.[7] These courts subsequently allowed recovery where the parties had attempted to reasonably estimate in advance the damages that might result from a breach. However, borrowing from the English courts, American courts also made sure that unreasonable provisions, or those whose damages could be construed as a penalty, would not be enforced.

III. Liquidated Damages Under the Restatement (Second) of Contracts

Although contract law and franchise law under the American common law system can vary from state to state, many state courts have adopted the Restatement (Second) of Contracts when analyzing the enforceability of liquidated damages provisions. Such adoptions have provided greater clarity and uniformity for and between contracting parties, especially with respect to key clauses like liquidated damages provisions that are frequently included in franchise agreements.[8]

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[3] William S. Harwood, *Liquidated Damages: A Comparison of the Common Law and the Uniform Commercial Code*, 45 FORDHAM L. REV. 1349, 1349 (1977).

[4] Susan v. Ferris, *Liquidated Damages Recovery Under the Restatement (Second) of Contracts*, 67 CORNELL L. REV. 862, 862 (1982).

[5] *Id.*

[6] *Harwood, supra* note 3.

[7] *Id.*

[8] The UCC and related case law is another consideration that courts may consider when determining whether liquidated damages are appropriate. The UCC covers the sale of goods. Section 2-718 of the UCC states that ". . . [d]amages 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."

Under the Restatement (Second) of Contracts, the validity of a liquidated damages provision turns on (1) the reasonableness of the stated liquidated damages amount compared to the amount of the anticipated loss as a result of the breach and (2) the difficulty of determining actual damages. The Restatement (Second) of Contracts provides:

> Damages for breach by either party may be liquidated in the agreement but only at an amount that is reasonable in the light of the anticipated or actual loss caused by the breach and the difficulties of proof of loss. A term fixing unreasonably large liquidated damages is unenforceable on grounds of public policy as a penalty.[9]

Through case law and statutes, most jurisdictions have adopted a reasonableness standard similar to that of the Restatement and incorporate the components of proportionality and difficulty in ascertaining actual damages.[10]

IV. The Benefits of Liquidated Damages

Liquidated damages provisions offer several benefits to the contracting parties, as well as the legal system. The enforcement of liquidated damages saves the time of courts, juries, parties, and witnesses, all while reducing the expense of litigation.[11] Liquidated damages provisions can add predictability by providing an agreed upon damage amount for certain types of breaches. They can promote a quicker, earlier resolution of a dispute since the damages result has already been determined.

Liquidated damages can be found in all types of contracts and are commonly found in franchise agreements. There are no limits on which types of industries use them. They are found in franchise agreements for the operation of hotels and lodging facilities, restaurants, shipping services, and all other types of businesses.

A. Liquidated Damages Promote Efficiency

Liquidated damages promote efficiency by eliminating a party's need to prove compensatory damages after one party's breach. Use of a liquidated damages provision eliminates the time and expense of retaining experts and having to engage in protracted legal proceedings to determine actual damages.[12]

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[9] Restatement (Second) of Contracts § 356 (1981).

[10] Dennis R. LaFiura and David S. Sager, *Liquidated Damages Provisions and the Case for Routine Enforcement*, FRANCHISE L.J. 175 (2001).

[11] Restatement, *supra* note 9, comment (a).

[12] LaFiura and Sager, supra note 10 at 177; Michael Pressman, *Article: The Two-Contract Approach to Liquidated Damages: A New Framework for Exploring the Penalty Clause Debate*, 7 VA. L. & BUS. REV. 651, 656 (2013) ("If there is no need to try the issue of damages, both the judicial system and the parties will avoid the extra time and expense associated with more litigation.").

"Compensatory damages are intended to compensate a plaintiff for actual injury or loss, and are designed to restore the injured party to as good a position as he would have been in if performance had been rendered as promised."[13]

The process of calculating compensatory damages, however, is not always easy, particularly when there is no readily identifiable benchmark or method for calculating them. This could result from the lack of sufficient historical sales or other information. It could result from various uncertainties associated with the business or for other reasons. Different courts may also define damages differently, applying different burdens of proof or other criteria. For example, in some states, lost profits are considered consequential damages and have special proof requirements.[14] In other courts, lost profits are considered direct damages, and not consequential damages.[15] With a liquidated damages provision, parties to the franchise agreement can be less concerned about how the jurisdiction in which they are litigating views lost profits or other types of damages. An enforceable liquidated damages provision can provide the agreed-upon amount to which the non-breaching party is entitled. Costs of litigation are likely to be less, as the parties no longer need to devote the same level of resources towards hiring experts to prepare reports supporting each side's compensatory damages calculation. The time from filing to judgment can also be shortened dramatically, avoiding the amount of time it normally takes for a case to be completed.

B. Liquidated Damages Add Predictability

Predictability plays an important role in the overall stability of the civil legal system.[16] "In the absence of stability and predictability in law, citizens have difficulty managing their affairs."[17] Parties to a contract have a vested interest in participating in a system that operates and resolves disputes in a way that stakeholders may anticipate, understand, and predict based on prior applications of the law. General consensus holds that more predictable courts function to provide better balance and cohesion for the determination of rights, and provisions like liquidated damages clauses have consistently affirmed the idea that parties prefer more certainty over less certainty in business dealings.

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[13] Frederick W. Rose, *Substantive and Procedural Aspects of Assuming Damages in Commercial Litigation*, 2004.

[14] *See, e.g.*, *DaimlerChrystler Motors Co., LLC v. Manuel*, 362 S.W. 3d 160, 184 (Ct. App. Tex. 2012); *Flagstaff Affordable Hous. L.P. v. Design Alliance, Inc.*, 223 Ariz. 320, 323 (2010).

[15] *Biotronik A.G. v. Conor Medsystems Ireland, Ltd.*, 117 A.D. 3d 551, 553 (App. Div. 1st N.Y. 2014).

[16] Stefanie A. Lindquist and Frank C. Cross, *Stability, Predictability and the Rule of Law: Stare Decisis as Reciprocity Norm*, Rule of Law Conference.

[17] *Id.*

Liquidated damages provisions help eliminate uncertainty associated with contractual breaches by giving the parties a compensatory framework from which actions triggering a payment obligation are clearly defined.[18] With a valid and enforceable liquidated damages provision in the franchise agreement, parties have a more precise understanding of the likely exposure when engaging in a pre-case assessment of the costs and benefits associated with resolving a dispute and the pursuit of other business interests. For example, liquidated damages can allow a franchisee to better consider the costs of a breach and compare them to the costs of performance both before and during the franchise relationship.[19]

C. Liquidated Damages Promote Settlement

Additionally, a liquidated damages provision may encourage an early settlement due to the mere presence of the amount specified in the provision.[20] Although the parties may disagree on issues regarding the enforceability or validity of a liquidated damages provision, a franchisee can evaluate its risk through a cost-benefit analysis framework, thus determining its desire to proceed with or take to steps to avoid litigation.[21] The leverage created by a valid and enforceable liquidated damages provision can cause disputes to settle that may otherwise be litigated.

V. Enforcing Liquidated Damages Provisions

In the context of franchise agreements, liquidated damages provisions are often not reciprocal, but they could be. Typically, they provide a stipulated amount due to the franchisor in the event that the parties' agreement terminates prematurely after a franchisee's breach of the franchise agreement. The breach could relate to a variety of circumstances, including failure to pay royalty or other fees, the wrongful cessation of business, delay in construction and/or development, or the unauthorized use of marks. The clause provides the franchisor the ability to recover an agreed upon amount of money for the damages incurred going forward.

Generally, a liquidated damages provision will be enforced if (1) it appears that the parties intended to liquidate damages; (2) at the time of contracting, the amount of damages specified was a reasonable estimate of the presumed actual damages that would result from a breach; and (3) at the time of contracting, it was difficult to ascertain

[18] Craig Enochs, *Negotiating Enforceable Liquidated Damages Clauses in Business Contracts*, Slide #5 (June 2, 2015).

[19] LaFiura and Sager, *supra* note 10 at 178.

[20] Larry A. Dimatteo, *A Theory of Efficient Penalty: Eliminating the Law of Liquidated Damages*, 38 AM. BUS. L.J. 633, 634 (2001).

[21] *See* LaFiura and Sager, *supra* note 10 at 178.

the amount of damages that would result from a breach.[22] Courts have held that all three elements must be met for a party to prevail on a claim for liquidated damages.

Thus, for the purpose of establishing each of these elements, it is important to draft the franchise agreement with heightened particularity, keeping the following key considerations in mind:

- Language and Labels Can Matter: the simplest way to help demonstrate that the liquidated damages provision is intended to be compensatory, rather than punitive, is to explicitly state the intent in the clause itself.[23]

- Specify the Type of Breach to Which the Liquidated Damages Provision Applies: including an explanation of the type(s) of breach that would give rise to the liquidated damages provision helps convey the parties' specific intent to utilize liquidated damages for a particular breach and also ensure that liquidated damages are being used only when determining damages would otherwise be difficult to do.[24]

- Provide a Reasonable Formula for Calculating the Liquidated Damages: case law across jurisdictions has developed a clear pattern regarding the use of a liquidated damages calculation; if the calculation results in a reasonable estimate of damages for the breach, the court will likely uphold the enforceability of the provision.[25] It is important to have information that supports the reasonableness of the liquidated amount.

- Choose Situations When Calculating Damages Would Be Difficult to Do: courts will enforce liquidated damages when it would be difficult to assess damages for a particular breach. Likely candidates for enforceable provisions include those intended to cover potential lost profits or other prospective damages that would be difficult to determine based on the surrounding circumstances.

A. Intentionality

The first requirement that generally must be established for a liquidated damages provision to be found enforceable is that the parties intended for there to be such a damages provision for a particular breach. Courts make use of as many resources available to ascertain the intent of the parties when evaluating a liquidated damages

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[22] Deborah S. Coldwell, Altresha Q. Burchett-Williams, and Melissa L. Celeste, *In this Issue, Liquidated Damages*, 29 FRANCHISE L.J. 211 (2010).

[23] Henry F. Luepke III, *How to Draft and Enforce a Liquidated Damages Clause*, 61 J. MO. B. 324, 327 (Nov.-Dec. 2005)

[24] *Id.*

[25] *Id.*

provision. “Courts will inquire into the intention of the [parties] by examining the other provisions of the contract, the subject matter, the nature of the contract, the surrounding circumstances, the ease or difficulty in ascertaining the amount of damages, the situation of the parties, and then from the whole decide whether the sum shall be treated as liquidated damages or as a penalty fixed to secure the performance of the contract.”[26]

Hospitality International v. Mahtani provides a good example of a court’s application of the intentionality requirement when determining the validity of a liquidated damages provision.[27] The provision provided:

> Upon the expiration or termination of this Agreement or any renewal thereof, Franchisee shall immediately:
>
> (a) Cease to be a Franchisee of Franchisor and cease to operate the former franchised business under the Hospitality Plan . . . .
>
> (b) Pay all sums owing to Franchisor. … the parties recognize the difficulty of calculating damages caused by lost future monthly franchise fees, but nevertheless recognize and agree that such damages will arise, and hereby agree to the following formula as a compromise between them on the calculation of such damages. Upon termination by Franchisor for any default by Franchisee, Franchisor shall be entitled, as liquidated damages and not as a penalty and solely to compensate Franchisor for lost future monthly royalty fees, advertising fees, and reservation sales fees for the period after the termination of this Agreement, to a sum equal to the product of the number of years remaining in the term, including any Renewal Term for which Franchisee has exercised its Renewal Option, of this Agreement (prorated for any period of less than a year) multiplied by an amount equal to fifty percent (50%) of the monthly average of the monthly royalty fees, advertising fees, and reservation sales fees earned (even if not paid) pursuant to paragraph 6(b) hereof over the twelve (12) month period ending with the last day of the month preceding the termination date … .

The court found that the intentionality requirement was met. Applying the tripartite test for determining enforceability, the court stated that the parties intended to provide for damages rather than a penalty. First, “the intent of the parties can be determined from the language of the contract construed as a whole, in addition to the language in the liquidated damages clause and the special circumstances of the case.” Second, “. . . the language of the provision, which used the specific words ‘liquidated

[26] Edward C. Dowling, *Liquidated Damages*, Historical Theses and Dissertations Collection at Cornell Law School, 1891, at 8.

[27] 1998 U.S. Dist. LEXIS 16445, at *53 (M.D. NC 1998).

damages,' evidenced an intent on behalf of both parties to provide for liquidated damages rather than a penalty." Third, ". . . both parties recognized that in franchise agreements liquidated damages provisions are commonplace."[28]

While adding explicit language to show intent is preferred, courts will also enforce liquidated damages when the circumstances demonstrate that intention. For example, in *Turner v. Atlanta Girls' School, Inc.*, the defendant-parents enrolled their daughter into a private school called the Atlanta Girls' School, signed the contract, and made the required deposit.[29] Three weeks after enrolling, the parents notified the school that their daughter would be enrolling at a different school, and would no longer attend. The school sued the parents demanding payment of the year's full tuition from them, relying on the liquidated damages provision in the contract.[30] The liquidated damages provision stated:

> I/We understand that (save as otherwise provided herein) the obligation to pay the tuition for the full academic year is unconditional and that no portion of such fees whether paid or due will be refunded or cancelled in the event of absence, withdrawal, or dismissal. If enrollment is cancelled prior to July 1, 2004 as a consequence of the Student ceasing to be resident in the Metro Atlanta area by the greater of (i) the current distance between Student's residence and AGS and (ii) a 35 mile radius from the School's location, the liability for tuition is limited to the enrollment deposit provided that written notification of change of residency is received by AGS prior to July 1, 2003.[31]

The appellate court affirmed the lower court's grant of summary judgment in favor of the school on the grounds that the liquidated damages provision was a valid and enforceable clause.[32] The court found that the parties clearly intended for the liquidated damages provision to apply in the event of a breach, writing:

> [W]hether a provision represents liquidated damages or a penalty does not depend upon the label the parties place on the payment but rather depends on the effect it was intended to have and whether it was reasonable. While the enrollment contract here does not use the label "liquidated damages," the language used is that of a liquidated damages clause in that it clearly sets forth what the damages for a breach shall be. Furthermore, the plain language of the contract does not provide for a

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[28] *Id.*

[29] 288 Ga. App. 115, 117 (Ct. App. 2007).

[30] *Id.*

[31] *Id.*

[32] *Id.*

> penalty. Because the contract language evinces an intent to establish damages of a year's tuition for any withdrawal of a student other than one necessitated by the student no longer being a resident of metropolitan Atlanta, the second prong of the liquidated damages test is satisfied.[33]

B. Reasonability

The most common disputes relating to liquidated damages provisions concern whether at the time of contracting, the amount of damages specified was a reasonable estimate of the presumed actual damages that would flow from a contractual breach. If the court finds that the amount specified in the liquidated damages provision is unreasonable, then the analysis ends and the clause is deemed unenforceable. *Shree Ganesh, Inc. v. Days Inns Worldwide, Inc.* is a good example of this occurring in the franchise context.[34] In *Shree*, the court found that the contract's liquidated damages clause was unreasonable and therefore an unenforceable penalty.[35] The agreement in dispute provided the following clause with respect to liquidated damages:

> If this Agreement terminates by action of the Licensee ... Licensee shall pay the Company within 30 days following the date of such event, as Liquidated Damages, because actual damages incurred by the Company will be difficult or impossible to ascertain, but not as a penalty, in an amount equal to the sum of accrued Recurring Fees during the . . . immediately preceding 24 calendar months (or such shorter period as equals the unexpired prior term of the date of termination, without regard to the express right to terminate the License Agreement prior to the expiration of the term).... Licensee shall also pay any applicable Taxes assessed on such payment. Notwithstanding the foregoing, in no event shall the amount payable pursuant to this Section be less than the product of $2,000 multiplied by the number of guest rooms in the facility. Payment of Liquidated Damages shall be in addition to the Company's other rights under this Agreement.[36]

At issue was the discrepancy between the "Recurring Fees" amount the provision required the Licensee to pay, and the calculated minimum amount. The court stated "[it] is swayed by the undisputed fact that the amount of damages as calculated based on the number of rooms is approximately five times the amount that would have resulted if the calculation were based on Recurring Fees. This is clearly excessive." [37] The court

[33] *Id.*

[34] 192 F. Supp. 2d 774 (N.D. Ohio 2002).

[35] *Id.*

[36] *Id.* at 785-86.

[37] *Id.* at 786-87.

then ruled that the liquidated damages clause was unenforceable and invalid, granting partial summary judgment for the plaintiff and striking the entire stipulated liquidated damages provision.

In *Radisson Hotels International, Inc. v. Kaanam, LLC*, the court enforced a liquidated damages provision that required the franchisee to pay as liquidated damages an amount based on five percent of daily gross room revenue for the immediately preceding twelve months multiplied by two.[38] The parties had entered into an agreement with a twenty-year term and the franchisee was terminated one year into the term based on its failure to pay required license fees. When finding the clause reasonable, the court noted that Radisson provided evidence that it routinely took two to four years to recruit, identify, evaluate, approve, and train a qualified hotel franchisee to replace a terminated franchisee. Evidence also showed that when one franchisee replaced another it took additional time for the new franchisee to reach the same level of profitability as the prior franchisee. In addition to obtaining liquidated damages, the court also permitted the franchisee to recover its actual damages for the time period prior to termination. The court properly found that the two types of damages were different. “Radisson receives one part of its actual damages (past-due fees) and a substitute for the other part of its actual damages (liquidated damages).” The court held that: “The award of liquidated damages will not preclude the recovery of actual damages when the former does not subsume the latter.”

On the other hand, the liquidated damages provision in *Leisure Systems, Inc. v. Roundup LLC* was held unenforceable as a penalty because the provision was unreasonable.[39] The clause stated:

> (c) Liquidated Damages. In the event this Agreement is terminated for any reason other than a default of [Franchisor], FRANCHISEE shall pay to [Franchisor] within fifteen (15) days after the effective date of termination, all sums then currently due and owing, plus liquidated damages in an amount to be determined as follows: (1) all sums then currently due and owing, plus the monthly average royalty and service fees paid or due to [Franchisor] from FRANCHISEE for the three year period immediately preceding the effective date of termination . . . (2) multiplied by the number of months remaining in the term of the Agreement; (3) which amount shall be reduced to the present value of such payments as of the date of termination assuming that such payments are made in equal amounts on January 1 of each calendar year remaining in the term of this Agreement, utilizing an interest rate of five percent . . . .

When analyzing the clause, the court held that the use of the monthly average royalty and service fees paid or due by the franchisee for the three years immediately preceding termination was reasonable. The amount relied on historical figures, would consider the individual circumstances of that franchisee, and the losses would be

[38] 2011 WL 98129 (D. Minn. Jan. 12, 2011).
[39] 2012 WL 5378302 (S.D. Ohio Oct. 31, 2012).

difficult to predict in the future. The court also found that the time period used was reasonable. The court held that the inclusion of a component for past due amounts in the liquidated damages clause rendered the clause an unenforceable penalty. The clause required the payment of past due amounts at the time of termination, but also required them to be paid prospectively for all of the remaining months on the contract. The court could also not discern any correlation between the past due amounts and the actual losses to be sustained by the franchisor going forward.

C. Unascertainability

Finally, for a court to find a liquidated damages clause valid and enforceable, the parties must not have been able to easily calculate damages that would result from the breach. This analysis is context and fact-specific, but normally not a frequent issue when it comes to the enforcement of liquidated damages provisions. In *Turner*, the court held that the damages flowing from the defendant-parent's breach was difficult to estimate because of circumstances concerning the particular school in question. The court stated that "[t]he school, which was not fully enrolled, operated at a fiscal loss, so each student's tuition was used to defray losses. When the contract was signed, the impact that one student's withdrawal would have on the overall financial condition of the school could not be accurately estimated since the final enrollment and final budget for the next school year was unknown." Situations where damages could be readily calculated on past amounts owed, for example, would not qualify for liquidated damages since the amounts would be ascertainable.

VI. Drafting Liquidated Damages Provisions

A. Best Practices for Drafting Liquidated Damages Provisions

"It is virtually the unanimous rule of all jurisdictions that whether a stipulation is for liquidated damages or a penalty is a question of law for the court."[40] While many of the factors that courts use to determine the validity of a liquidated damages provision may vary state-by-state, the underlying dispute of whether a liquidated damages provision is a valid and enforceable part of the franchise agreement will be decided by the court or arbitrator. To that end, it is important that a party that may one day seek to enforce a liquidated damages provision ensure that it has taken the best possible steps to facilitate a positive judgment from the court or arbitrator on this question.

The following tips should be considered when drafting a liquidated damages provision or reviewing an existing provision for the purposes of determining enforceability. While these "best practices" do not necessarily guarantee the enforceability of a particular liquidated damages provision, they will certainly help undermine the breaching party's ability to claim that the provision is invalid.

1. Specify Damages

[40] *Leisure Sys. v. Roundup LLC*, 2012 U.S. Dist. LEXIS 155948 (S.D. Ohio Oct. 31, 2012).

First, the liquidated damages provision should clearly state that the damages at issue are difficult to formulate, uncertain, and inexact at the time of the franchise agreement. Absent the inclusion of this key language, the odds of success with respect to enforcement of the liquidated damages provision can decrease.[41] The court or arbitrator would need to glean the necessary evidence of intent from the surrounding circumstances and other available evidence.

2. Clearly State the Clause Is Not a Penalty

Proper construction of a liquidated damages provision should always include language that clearly states that the parties do not consider the clause to be a penalty. For the party enforcing the liquidated damages provision, such an addition can only increase the likelihood that a court will find the clause to be valid and enforceable. In *Days Inn of America, Inc. v. Patel*, a hotel franchisor sued a franchisee for breach of contract, and asserted a claim for liquidated damages. The court granted summary judgment in favor of the franchisor and found that the liquidated damages provision in the franchise agreement was valid and enforceable. Finding that the liquidated damages clause was not punitive, the court articulated that the franchisee admitted such because the section "clearly states that the clause is not a penalty."[42]

3. Consider All of the Provisions in the Contract and How They Interact

"In drafting a liquidated damages clause, special concern should be used to understand its relationship to other provisions in the contract or in the law."[43] For example, under New York law, a force majeure clause "excuses a party from performing its obligations if the failure is caused by a condition outside its control, such as a performance failure caused by a natural disaster."[44] If a franchise agreement has a force majeure clause associated with the terms of performance, can a liquidated damages provision still be enforced against the non-performing party? These are important questions to ask when evaluating whether a liquidated damages clause will operate effectively and consistently with the parties' intentions.

The answer to these types of questions may depend on whether the force majeure clause includes a carve-out exempting certain events (such as labor unrest,

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[41] It is worth mentioning, however, that inclusion of said language is necessary but not sufficient to prove that a liquidated damages provision is enforceable. In the *Ganesh* case mentioned previously, the franchisor included language stating that actual damages incurred at the time of contracting were difficult and impossible to ascertain, yet the court still concluded after conducting its own review that the damages amount was clearly excessive.

[42] 88 F. Supp. 2d 928, 936 (C.D. Ill. 2000).

[43] Larry A. DiMatteo, A Theory of Efficient Penalty: Eliminating the Law of Liquidated Damages, Am. Bus. L. J. 673 (2001).

[44] *Premier Entm't Biloxi LLC v. U.S. Bank Nat'l Assoc. (In re Premier Entm't Biloxi LLC)*, 445 B.R. 582, 591 n.24 (S.D. Miss. 2010).

increases in prices, change of law, etc.), or if the non-performing party must first attempt to mitigate its damages before relying on the non-performance out.

Because franchise agreements can drastically vary according to the goals and interests of the contracting parties (and also the type of business), it is important that all sides understand that the franchise agreement as a whole can impact how the liquidated damages provision is enforced, and act accordingly.

4. Choose Your Language Carefully

When drafting a liquidated damages clause, it is imperative to avoid language that may signal to the court that the provision could potentially be invalid based on content alone. The words "penalty," "deterrent," "discipline," "punishment," or anything similar should never be included in a liquidated damages clause. Additionally, a liquidated damages provision should not include language that suggests that the liquidated amount is greater than the actual damages expected. This was the case in *Shree*, and the court ultimately found that the liquidated damages clause was an unenforceable penalty.[45] Further, language that suggests that damages would be easy to calculate at the time of the breach should also be avoided, as that has the potential to invalidate the liquidated damages provision.

5. Consider the Reasonableness of the Recovery

It is important to keep in mind the reasonableness of the recovery contemplated by the liquidated damages provision. There are a variety of factors a court or arbitrator may consider. While the focus is normally on whether the liquidated damages provision is reasonable at the time of contracting, courts and arbitrators may consider the total value of the contract; historical profits or other information from when both parties were performing as intended under the agreement; the time period over which the damages are calculated; the difficulty of determining damages and the risks involved; and the difference between the liquidated damages amount and actual damages or the amounts the party seeking liquidated damages would have received had the other party performed. In general, courts and arbitrators will not enforce a liquidated damages provision that seems like a penalty. The more factors supporting the liquidated damages formula, the more likely it will be enforced as written.

6. Think About the State Law Governing Your Agreement

Because liquidated damages provisions are governed by state law, it is important to know the law that governs the franchise agreement. Some states may focus on certain criteria when determining whether to enforce a liquidated damages provision. For example, under New York law, "when analyzing whether liquidated damages provisions in franchise contracts function as penalties, courts often scrutinize the length

[45] *See* 192 F. Supp. 2d 774, *supra* note 34.

of time the liquidated damages provision compensates the franchisor."[46] Thus, state law should always be considered before seeking enforcement of a liquidated damages provision. For this and other reasons, it should also be considered before selecting a particular state's law to govern the franchise agreement.

Certain states such as Minnesota and North Dakota vary substantially from the rest of the nation and provide good examples of situations where a liquidated damages provision is materially limited and/or cannot be enforced as written as a matter of state law. Under the Minnesota Franchise Act, parties are precluded from seeking liquidated damages on the basis of a premature termination of a franchise license agreement. A liquidated damages provision can be used if the court determines that the provision is a reasonable method for calculating actual lost profits.

North Dakota has completely taken away the option of including a liquidated damages provision in a franchise agreement. Under North Dakota's State Franchise law, the State Securities Commissioner has the authority to determine certain provisions invalid in a franchise agreement. Pursuant to Section 51-19-09 of the Act, the Securities Commissioner has found liquidated damages provisions to be "unfair, unjust or inequitable" to North Dakota franchisees, thus eliminating its ability to be enforced or included under North Dakota franchise law.

Other states are more favorable to liquidated damages provisions. For example, some states include favorable court procedures for obtaining default judgments if damages are liquidated. "Under Florida law, non-breaching parties may secure a default judgment if the agreement provides for liquidated damages, but not if the agreement provides for unliquidated damages, as the defaulting party has a due process entitlement to notice and an opportunity to be heard as to the presentation and evaluation of evidence necessary to a judicial interpretation of the amount of unliquidated damages."[47]

B. Examples of Liquidated Damages Provisions Found to be Valid

. . . in the hotel context

In *Ramada Franchise Systems, Inc. v. Motor Inn Inv. Corp.*, the issue of whether a liquidated damages provision was valid and enforceable was raised and had to be resolved by the Georgia courts. The applicable provision stated:

> 15. Default. Any of the following events will constitute a default and be good cause for Ramada to terminate the License without prejudice to any other rights or remedies which Ramada may have and exercise: ...

[46] *Captain D's, LLC v. Arif Enters.*, 2010 U.S. Dist. LEXIS 129242, at 25 (M.D. Tenn. Dec. 6, 2010) (citing *Howard Johnson Int'l Inc. v. HBS Family*, 1998 U.S. Dist. LEXIS 11040 (S.D.N.Y. July 21, 1998)).

[47] *Bodygear Activewear, Inc. v. Counter Intelligence Servs.*, 946 So. 2d 1148, 1150 (Fla. 4th Dist. Ct. App. 2006).

> (b) Licensee ceases to operate the Hotel, defaults under any lease or sublease of the Hotel, or loses possession or the right to possession of all or a significant part of the Hotel, provided that if the loss of possession is due to governmental exercise of eminent domain, or if the Hotel is damaged or destroyed by fire or other casualty; then the provisions of Section 16 [Loss of the Hotel by Condemnation or Casualty] shall apply.

If the License is terminated pursuant to ... (b) ..., Licensee will immediately pay Ramada (as liquidated damages for premature termination and not as a penalty or as damages for any breach of the Agreement or as a substitute for other payments due to Ramada) an amount equal to the greater of (x) $50,000 or (y) the sum of all monthly payments required under Section 6 [Fees] during the 24 months preceding termination (or such shorter number of months between the date of termination and the date of expiration of the term of the License).

Licensee will pay all costs, expenses and reasonable attorneys fees incurred by Ramada in enforcing the terms and conditions of this Agreement."[48]

The court found that this liquidated damages provision was valid and enforceable because:

- "The harm caused by a breach in this case is of a kind that is difficult or impossible to estimate accurately."
- "The intent of the parties can be determined from the language of the contract construed as a whole, in addition to the language in the liquidated damages clause and the special circumstances of the case."
- "The language of the agreement evidences an intent on behalf of the parties to provide for liquidated damages, rather than a penalty."
- "The stipulated sum was a reasonable pre-estimate of the probable loss."

. . . in the station ownership context

An Illinois federal court upheld the enforceability of Mobil's liquidated damages provision, which stated:

Liquidated Damages. It is understood that Mobil is relying on sales to Dealer of the minimum product quantities set forth in Article II, Paragraph A, and that any repudiation of this Agreement and failure to purchase

[48] *Ramada Franchise Systems, Inc. v. Motor Inn Inv. Corp.*, 755 F. Supp. 1570, 1572 (S.D. Ga. 1991).

> those minimum product quantities by Dealer will result in serious losses to Mobil. Dealer and Mobil acknowledge that the amount of those losses is and will be difficult to determine. It is agreed, therefore, that upon any repudiation of this Agreement by Dealer, Dealer shall pay to Mobil, as liquidated damages to compensate for such losses, two cents per gallon multiplied by the minimum number of gallons set forth in Article II, Paragraph A, measured from the time of repudiation to the end of the term of this Agreement. The damages here liquidated are confined to losses resulting from the Dealer's repudiation of this Agreement, and shall not affect such other rights and remedies as Mobil may have under this Agreement and under applicable law including, but not limited to, the PMPA and the Uniform Commercial Code."[49]

The court found that this liquidated damages provision was valid and enforceable because the damages were a reasonable estimate of the actual damages that Mobil would be entitled to from the dealer. The language of the liquidated damages provision also reflects the qualities that the *Ramada* court used to conclude enforceability. Here, the provision and the court's analysis establishes intentionality, reasonability, and ascertainability–all necessary qualities to prove that a liquidated damages provision is valid and enforceable under the law.

. . . in the restaurant context

In *Captain D's, LLC v. Arif Enters.,*[50] the United States District Court for the Middle District of Tennessee entered an order awarding the franchisor liquidated damages in the amount of $719,031.54 as a result of the franchisee's breach of numerous License Agreements. Captain D's filed suit in federal court, alleging a breach of the License Agreements signed with one of its franchisees, which required the franchisee to operate five Captain D's franchise restaurants according to the standards and uniformity of operation provisions in the License Agreements. The liquidated damages provision stated:

> Upon termination of this Agreement . . ., all rights of Licensee hereunder shall cease, and Licensee shall pay to Licensor all sums then due plus damages for the right to receive the royalty fees for each year or portion thereof remaining in the original term of this Agreement, together with any other damages suffered by Licensor as a result of such default, and Licensee shall have no further claim hereunder. . . . Licensee shall pay to Licensor in addition to any amounts found to be due and owing, all expenses incurred by Licensor as a result of any such default, including reasonably attorneys' fees. . . .

[49] *Mobil Oil Corp. v. Flores*, 175 F. Supp. 2d 1080, 1081 (N.D. Ill. 2001).

[50] 2010 U.S. Dist. LEXIS 129242 (M.D. Tenn. 2010).

At issue was the portion of the liquidated damages provision that required defendant to pay plaintiff future royalty fees for the remaining length of the franchise agreement. The defendants attempted to argue that the provision was an unenforceable penalty, but the court easily rejected this assertion, stating that the defendants failed to provide any support for that contention. Further, the court in Captain D's articulated a litany of analogous cases which found future fees to be reasonable under a liquidated damages provision.[51]

C. Examples of Liquidated Damages Provisions Found to be Invalid

. . . in the services context

In *Telenois, Inc. v. Village of Schaumburg*, the Plaintiff cable television franchise brought an action against the franchisee, seeking to recover $100,000 that defendant took and retained pursuant to a franchise agreement between the parties.[52] The court ruled that the liquidated damages provision was an impermissible penalty. The relevant parts of the provision read as follows:

> With the signing of this Agreement Section, Franchisee [Telenois] shall reconfigure the system as follows:
> (a) The Village will be served from a headend located within the Village limits.
> (b) The cable plant will be converted from an active dual-trunk system to a single-trunk active system, with the physical integrity of the second trunk maintained for use as a backup. The active electronics of the second cable shall be removed.
> (c) In areas currently served, amplifier cascades will be significantly reduced to worst-case levels of 25 amplifiers from the current level of 35 amplifiers.
> (d) The return-line currently connected to Village Hall will be extended to the prairie Center for the Arts to allow live cablecasting from the Prairie Center.
> (e) Two monitors will be installed inside the Village Hall to allow alphanumeric messages to be shown to visitors in the main business areas.
> This system reconfiguration will be completed by December 31, 1988. Franchisee will provide the Village with an unconditional Letter of Credit in the amount of One Hundred Thousand Dollars ($100,000) to be payable

[51]The time period of recovery is closely reviewed by the courts. *See Radisson Hotels Int'l, Inc. v. Majestic Towers, Inc.*, 488 F. Supp. 2d 953, 959-60 (C.D. Cal. 2007) (finding two years to be a reasonable time estimate for damages); *Century 21 Real Estate LLC v. Berosa Corp.*, 666 F. Supp. 2d 274 (E.D.N.Y. 2009) (enforcing a liquidated damages provision that calculated royalty payments for the 98 months remaining under the agreement); *Travelodge Hotels, Inc. v. Kim Shin Hospitality, Inc.*, 27 F. Supp. 2d 1377, 1382-83 (M.D. Fla. 1998) (finding a liquidated damage provision of five years for royalty payments reasonable where franchises breached an agreement not set to expire for 18 years). If the period is too long, a court may consider the provision to be a penalty.

[52] 256 Ill. App. 3d 897 (1st Dist.1993).

to the Village. In the event the Franchisee fails to complete this reconfiguration by December 31, 1988, the Village will collect the full amount as a penalty."

The court concluded that the liquidated damages provision was unenforceable because of the unreasonably large amount the defendant was required to pay. Deposition testimony from Defendant-representatives made it clear that the provision was intended to be a penalty.[53]

. . . in the hotel context

Howard Johnson Int'l Inc. v. HBS Family involved a franchisor seeking $224,000 in liquidated damages for the franchisee's termination of the franchise agreement.[54] The liquidated damages provision stated:

> If this Agreement terminates by action of the Licensee or under Section 19(a) or (b), Licensee shall pay Howard Johnson within 30 days following the date of such event, as Liquidated Damages, because actual damages incurred by Howard Johnson will be difficult or impossible to ascertain, and not as a penalty, an amount equal to the sum of accrued Recurring Fees during the immediately preceding 24 full calendar months (or such shorter period as equals the unexpired Term at the date of termination, without regard to any express right to terminate the License prior to the expiration of the Term); provided, however, if the Facility has been open for less than 24 months, then the average monthly Recurring Fees since the Opening Date multiplied by 24, plus any applicable Taxes assessed on such payment. Notwithstanding the foregoing, in no event shall the amount payable pursuant to this Section be less than the product of $2,000.00 multiplied by the number of guest rooms in the Facility.[55]

The court found the liquidated damages provision to be invalid because it set an absolute minimum liquidated damages payment in the last sentence. The court ruled that the fixed sum, on which the $224,000 demand was based, was "not a reasonable estimate of the potential loss likely to be suffered because it does not take into account

[53] *Id.* at 902 ("George Longmeyer (Longmeyer) defendant's manager, testified at his deposition that 'the purpose of the letter of credit was to insure that they would [complete the reconfiguration in a timely manner]; and if they didn't, that letter of credit was to serve as a penalty to do so because of their lousy track record in the past of not completing things. That was the whole purpose of that letter of credit.' Likewise, Dr. Orton, defendant's cable consultant and drafter of section 31, wrote in his January 6th report that to assure that the reconfiguration was accomplished in a timely manner, the Village required the $ 100,000 letter of credit, and structured it so as to be able to cash it as a penalty in the event of non-completion." Defendant, on page 13 of its brief also conceded that section 31 imposed a penalty provision. As such, the letter of credit clause was against public policy and, therefore, unenforceable.")

[54] 1998 U.S. Dist. LEXIS 11040, at *20.

[55] *Id.*

the length of time remaining on the unexpired License Agreement at the time of default. Unlike the first method for calculating damages above, this 'estimate' is not proportional to the possible loss."[56]

An additional hotel franchise case that found the accompanying liquidated damages provision invalid is *Howard Johnson Int'l, Inc. v. Inn Development, Inc.*[57] *Captain D's, LLC* provides a succinct explanation of the liquidated damages provision. "In *Inn Development*, a franchisee breached the terms of a 15-year licensing agreement after approximately 1.5 years operating a hotel. In rejecting the contract's specified damages clause that is similar to the royalties damage provision here, the court noted that allowing for recovery over 13 years would result in an unwarranted windfall to Howard Johnson. In ruling the provision a penalty, the court noted that the amount requested was not a normalized dollar amount, that it was unreasonable to expect a franchisor to not mitigate its damages over the entire 15 year period, that such an award would go against public policy of discouraging economic waste, and that the damages were both speculative and unreasonable."[58]

VII. Litigating Liquidated Damages Provisions

State and federal courts have been consistent in articulating the necessary form and content a liquidated damages provision must embody for it to be found valid and enforceable. From this, there has developed a key set of defenses that are normally used by the party seeking to avoid application of a liquidated damages provision. That party generally bears the burden of showing why the clause should not be enforced as written. However, if there are doubts about the provision, courts will generally favor finding the clause to be unenforceable.

A. Key Defenses

1. *Unenforceable Penalty*

A court will not enforce a liquidated damages provision that is against public policy.[59] "A clause which provides for an amount plainly disproportionate to real damage is not intended to provide fair compensation but to secure performance by the compulsion of the very disproportion. A promisor would be compelled, out of fear of economic devastation, to continue performance and his promisee, in the event of default, would reap a windfall well above actual harm sustained."[60][61]

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[56] *Id.*

[57] 2009 U.S. Dist. LEXIS 82976 (D. S.D. 2009).

[58] *Id.*

[59] *See Truck Rent-A-Center, Inc. v. Puritan Farms 2nd, Inc.*, 361 N.E. 2d 1015, 1018 (Ct. App. 1977) ("liquidated damage provisions will not be enforced if it is against public policy to do so and public policy is firmly set against the imposition of penalties or forfeitures for which there is no statutory authority").

[60] *Id.*

A party seeking to defend against a liquidated damages provision should attempt to characterize the liquidated damages provision as a penalty that is not proportionate to or reasonably close to the damages incurred by the non-breaching party. This may be accomplished by comparing actual damages to the liquidated damages; highlighting the length of time over which the non-breaching party is being compensated; or arguing that the non-breaching party may receive double or duplicative recovery as a result of the liquidated damages provision.

2. *Lack of Intent*

If the court concludes that the parties did not intend for the liquidated damages provision to cover the breach in question, then the breaching party will not be held liable for the stipulated damage amount. In *Ravenstar LLC v. One Ski Hill Place LLC,*[62] a group of company-condominium buyers defaulted on the contract that contained a liquidated damages provision allowing the seller to retain the buyers' deposits in the event of default. The plaintiff-appellants sought to invalidate the liquidated damages provision on the grounds that the parties did not intend to liquidate the damages because the contract allowed the seller to either (a) seek actual damages or (b) pursue liquidated damages. The Colorado Court of Appeals, disagreeing with the buyers, affirmed the judgment of the trial court, holding that "the parties in this case expressly intended to make liquidated damages one of the available remedies that [defendant] could pursue." Here, the mere presence of an option to seek actual damages did not render the liquidated damages provision invalid.[63]

To prevail on the argument that the parties did not intend to liquidate damages in the contract, courts look at the language of the contract, the facts associated with the case, and any other evidentiary support that would assist the judge in coming to a conclusion. The Minnesota Supreme Court articulated its approach in understanding intent in *Frank v. Jansen*, which involved a dispute arising out of a real estate transaction.[64] At issue was whether the parties intended for liquidated damages in the event of breach. The court stated that "whether the parties have stipulated for liquidated damages must be gleaned from the contract and all of the facts pointing to the intention of the parties. Before there can be a finding of liquidated damages, there must be evidence to support a finding that the parties intended the stipulated amount to be in lieu of compensatory damages."[65]

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[61] *Rescuecom Corp v. Chumley*, 2011 U.S. Dist. LEXIS 31928 (N.D.N.Y. 2011) (court held that the stipulated damages provision constituted an unenforceable penalty because it was unconscionable under New York law).

[62] 2016 COA 11 (Jan. 28, 2016).

[63] *Id.* at ¶ 37.

[64] 303 Minn. 86 (1975).

[65] *Id.* at 93.

3. *Damages Are Easily Determinable.*

If the court determines that liquidated damages are unnecessary because actual damages would be readily ascertainable at the time of contract formation, then the provision may be held unenforceable. For example, liquidated damages would not be proper if actual damages can be determined based solely on historical activity or other available information.

4. *Unconscionability and Other Contract-Based Defenses.*

In addition to the more typical defenses challenging liquidated damages provisions, sometimes parties will seek to render the clause and/or contract unenforceable by claiming that the provision was procedurally or substantively unconscionable. Procedural unconscionability concerns how the contract was formed and challenges the provision based on lack of notice or other procedural defects. Substantive unconscionability seeks to challenge a clause or contract based on the unfairness of the provision or public policy. If appropriate, parties challenging liquidated damages provisions can also seek to avoid enforcement of the liquidated damages provision by challenging the alleged breach or other actions relating to the contract based on waiver, estoppel, fraud, ratification, or other typical contract defenses. The enforcement of a liquidated damages provision can also trigger claims in response that raise additional issues between the parties, all of which could be decided together.

VIII. Conclusion

Liquidated damages provisions are effective and common tools that allow non-breaching parties to avoid the complicated and sometimes difficult task of calculating damages after a breach. To ensure that the liquidated damages provision will be found valid and enforceable in the event of a dispute, parties, at the time of contract formation, must carefully consider the provision and examine its language, keeping in mind that a liquidated damages provision, at a minimum, should: (1) specify that the parties are seeking to liquidate damages and not create a penalty; (2) be reasonable when determining the liquidated amount; and (3) select options for liquidated damages only where damages would be difficult to calculate at the time of contract formation.