Andrews Myers

Supreme Court Examines When Liquidated Damages Are an Unenforceable Penalty

The Texas Supreme Court recently considered an appeal challenging the enforceability of liquidated damages in a breach of contract dispute, and whether the liquidated damages were an impermissible "penalty." At issue was an early termination provision which resulted in over $700,000.00 in liquidated damages. The Court in ***Atrium Medical Center, LP v Houston Red LLC*** affirmed the lower court's decision enforcing the liquidated damages provision holding that the plaintiff had not proved that the liquidated damages provision operated as a penalty. Importantly, in its analysis the Texas Supreme Court confirmed that Texas is a "second look" jurisdiction with regard to enforcement of liquidated damages.

Traditionally, liquidated damages clauses must meet two elements: (1) damages or harm caused by the breach are difficult (or incapable) to estimate; and (2) the amount for liquidated damages is a reasonable projection of just compensation. To determine whether these elements are met, courts will examine the facts surrounding the parties at the time the contract was made. In applying these first two elements alone, the actual damages sustained by the party seeking to enforce the liquidated damages do not come into play. The party attempting to enforce the liquidated damages bears the burden to prove these two elements.

More recently, some jurisdictions, including courts in Texas, have begun adding a third element to the analysis which necessarily requires an examination of the *actual damages* a party incurred at the time of the breach compared to the liquidated damages amount stipulated in the agreement. The addition of this third element has been called a "second look" (or modern) approach because it requires some level of retrospective analysis and is used by parties challenging an otherwise enforceable liquidated damages provision under the traditional (single-look) approach. In supporting this notion, the Court in *Atrium* stated that if an "unacceptable disparity" with "no rational relationship to actual damages" exists between actual damages and liquidated damages, then the provision may be an unenforceable penalty.

Essentially, *Atrium* declares that, even where a liquidated damages provision is negotiated at arms' length between the parties and was a reasonable forecast of damages at the time the contract was executed, under this second-look approach, the liquidated damages provision may not be enforced if actual damages are substantially lower than the liquidated damages. Texas Courts will now review the amount of the liquidated damages, the amount of the actual damages incurred by the party seeking to enforce liquidated damages, and that party's efforts to mitigate the damages.

The Supreme Court emphasized that Texas still supports parties' ability to contract freely, but cautioned that such a notion is limited by the rule that damages cannot exceed "just compensation." Determining the difference between an enforceable liquidated damages provision and an impermissible penalty has been called one of the most subtle questions of law. And the decision in *Atrium* does little to simplify the analysis. Drafting to address these recent decisions may be equally nuanced.

Practically speaking, it is important to consider all three of these elements while drafting, and consult with a lawyer to document these issues before execution and during the performance of a contract.

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