

Why Show Actual Damages When Contract Has a Liquidated Damages Clause?

“When you negotiate and execute a contract with a liquidated damages clause, it’s natural to feel like you have a safety net – that in the event of a dispute you can rely on the contract to protect you from having to go through the costly and time-intensive exercise of proving your actual damages. But parties fighting an obligation to pay liquidated damages often say that the contract clause amounts to an unenforceable penalty,” warns D. Ferguson McNiel, III and Stephanie L. Noble in Vinson & Elkins *Insights*.

“This argument usually involves a claim that the liquidated damages provided for in the contract far outweigh the damages actually incurred, leading to a fight over what the actual damages are. The Texas Supreme Court’s recent decision in *Atrium Medical Center LP v. Houston Red C LLC*, clarifies the burden of proof in these cases and shores up the value of a well-drafted liquidated damages provision.”

“Under Texas law, the inquiry to determine whether a liquidated damages clause is an unenforceable penalty requires three questions: (1) At the time of contracting, did the clause reasonably estimate the harm that would result from a breach; (2) Were actual damages difficult to predict when the contract was made; and (3) Whether, at the time of the breach, the liquidated damages provided in the contract exceeded the actual damages incurred?¹ The first two questions require consideration of the information available at the time the contract was executed, i.e., whether the provision was an unenforceable penalty from the beginning. The last question relies on the premise that a provision not designed to be a penalty can nevertheless operate as one, based on the

circumstances arising at the time of the breach.”

Read the article.