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CONSTRUCTION

Liquidated Damages Provision - Texas Law

By: Keith Langley

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Moral – read the full contract and introduce evidence!

The Texas Supreme Court ruled that a provision not designed to be a penalty can nevertheless operate as a penalty but determined here that the liquidated damages provision was not proved by the briefing party as an unbridgeable discrepancy or otherwise demonstrated that the provision operated as a penalty. Accordingly, in this construction contract case the provision was upheld. *Atrium Medical Center, LP v. Houston Red C LLC*, No. 18-0228, February 7, 2020 (Tex.).

When the owner of a 60 bed acute care hospital encountered financial distress and stopped paying for specialty laundry services, the legal question was whether the laundry service provider is entitled to $716,330.95 based on the four years remaining on the contract, a cancellation charge of 40%. A Texas court will not enforce a penalty but instead will enforce actual damages.

The trial court ruled that the LD provision was not a penalty and the service provider was entitled to the contractual profit. The appellate court affirmed, finding that actual damages were very difficult if not impossible to determine. The appellate court also found, based on the evidence, that 40% was a reasonable forecast of the harm resulting from canceling the contract.

The Texas Supreme Court stated that a liquidated damages provision must ensure adherence to the principle of "just compensation" in Texas. The party seeking to enforce liquidated damages has the burden of showing that (1) "the harm caused by the breach is incapable or difficult of estimation" and (2) "the amount of liquidated damages called for is a reasonable forecast of just compensation".

The Court went on to state that a properly designed LD provision can still operate as a penalty due to unanticipated events arising during the life of a contract. If this "unbridgeable discrepancy" exists the court must not enforce the LD provision. The party challenging the LD provision must demonstrate this unbridgeable discrepancy. The service provider ImageFirst was entitled to benefit of the bargain damages, not lower out of pocket costs. The difficulty of estimation was determined at the time of contracting. On the reasonable forecast of just compensation the Court found that the service provider ImageFirst had testified to a gross margin profit of near 40% over the years. Determination of whether an LD provision is a penalty is a legal question.

The Court stated that where a contract, not here, facially imposes amounts beyond just compensation, the LD provision as drafted violates the first test. A provision that uses the same damage measure for breaches of varying magnitude is facially unreasonable. Here the contract provision did not multiply actual damages nor penalize similar breaches with the same broad brush.

Having found the provision enforceable as to the first test, the Court turned to the second test and here the burden was on the owner Atrium to show an unbridgeable discrepancy between actual and liquidated damages. Here the evidence did not demonstrate such a discrepancy so the provision was enforceable. The defendant owner Atrium had to show the LD's compared to actual damages. Atrium showed no actual damages and showed no lack of mitigation by the service provider ImageFirst. The burden of proof is on the party claiming that actual damages could have been and were not reduced. Here the owner provided no evidence that the service provider could not handle a replacement contract. Accordingly the owner did not show an unbridgeable discrepancy between the service provider's actual and liquidated damages. As here, when an LD provision is facially reasonable the breaching party must provide evidence of an unbridgeable discrepancy.

A liquidated damages clause may be enforceable or may be challenged. Know the actual damages, whether those damages were known at the time of contracting, and the actual damages of the injured party at the time of beach. Meanwhile, be careful out there!

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We hope that these changes make big differences in the future.

Well done is better than well said.

- Benjamin Franklin

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