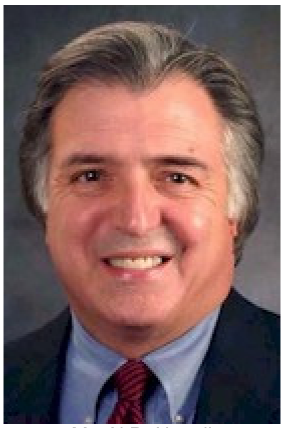
Hotel Business Review
Best practices, insights & trends

Liquidated Damages: Protecting Your Franchise's Good Name

By Albert A. DeNapoli, Esq., Partner, Tarlow Breed Hart & Rodgers, P.C. and Michael J. Radin, Esq.


Mr. Al DeNapoli

Cicero tells the story how in ancient Syracuse, Damocles gave back the throne to the reigning king when he realized the king had perched above him a sword hanging from a fine thread. Liquidated damages, in some instances, work like the proverbial "Sword of Damocles": hovering above the parties as a threat in case of a breach of contract.

While the law in each state differs as to the use and acceptance of liquidated damages, the most widely-used basis for a generic explanation of the concept of liquidated damages comes from the Restatement of the Law: Contract Second:

> *Damages for breach by either party may be liquidated in the agreement but only at an amount that is reasonable in light of the anticipated or actual loss caused by the breach and the difficulties of proof of loss. A term fixing an unreasonably large liquidated damage is unenforceable on grounds of public policy as a penalty. (p. 157)*

When entering agreements in which you believe you may not be able to easily assess damages that may be caused by a breach, and/or you wish to keep the other party focused on the amount of damages it may face if it fails to perform, liquidated damages can be a valuable tool and "weapon". Unlike the "Sword of Damocles", however, liquidated damages are, in many instances, a double edged sword. Especially be careful in those instances where they are used clearly more as a sword to punish than a shield to protect. As set forth above in the Restatement, most courts will strike them down in those instances as an unenforceable penalty.

Courts in most jurisdictions, when reviewing a claim for breach of contract and are faced with a liquidated-damages clause in the contract allegedly breached, will examine in the first instance to see whether the liquidated damage clause results in reasonable compensatory damages or whether in fact the liquidated damages are tantamount to an unreasonable penalty.

Contract damages are not meant to be punitive, but instead to be compensatory. Generally, when a contract is breached, courts look mainly to compensate the party against whom there was a breach for the damages it suffered as a result of the breach. If in fact the damages are too speculative and/or incapable of determination, the courts will not award damages. Often, to avoid this situation, among other reasons, contracts will contain a liquidated damage clause.

Liquidated damages are generally based on a mathematical formula to be applied simply such as using an agreed-upon dollar figure multiplied by the days of the breach. Such liquidated damage clauses are often found in construction contracts. When a construction project is completed later than the agreed-upon completion date, liquidated damages may be agreed and assessed at a certain dollar figure based upon each day following the agreed-upon completion date by which the project is not complete.

Aside from construction contracts, many other agreements in the hospitality industry, including hotel operations, management agreements, guarantees, lender/manager contracts, and franchise agreements, to name a few, also provide for liquidated damages based upon a certain dollar figure multiplied by the number of days from the breach to the anticipated completed term of the agreement. Sometimes in certain agreements the number of guest rooms at a facility may also be a multiplying factor. In many purchase agreements, including those for the purchase and sale of hotels, the remedies will provide for the seller to retain the deposit as liquidated damages, in case of buyer's failure to close.

In those instances where the parties wish to increase the likelihood that the liquidated damage provision will be upheld, the provision will state that the liquidated damage, such as the retention of a deposit, is reasonable in light of the impracticability to ascertain the actual damages. In those situations and others, where the value of the damage is incapable of being precisely calculated, courts may be more inclined to uphold a liquidated damage clause exactly because of this inability to precisely calculate the compensatory damages. It is in these circumstances in particular, where the calculation of damages may be impossible and, therefore, too speculative for the court to award as compensatory damages, such as a manager's breach to a lender in an agreement between the lender and the manager, that the parties should consider liquidated damages as an alternative remedy in case of a breach. The converse, of course, is true for parties, such as managers, who may want to attempt to avoid the likelihood of being assessed damages: the liquidate damage clause should be avoided. Be careful, however, in doing so, because it may be that the liquidated damages being offered by the other side will be less than the actual compensatory damages. While parties entering a contract do not generally have their eye on a future breach, it behooves contracting parties to look closely at the damage provisions to protect themselves.

In operational agreements in the hospitality business, courts will sometimes determine that, although the actual damages cannot be precisely calculated due to variables such as weather, travel options, market conditions, actions by competitors, etc., damages are reasonable when it can be shown that based upon the variables the damages could have been significantly greater or lower than the amount the liquidated damage remedies provided.

In any event, the basic yardstick, used in those courts which would award liquidated damages is whether the amount is reasonable. Some courts will use a two prong test and consider reasonableness both at the time at which the contract is entered, and then review the liquidated damage provision and amount again to determine if it is also reasonable at the time of the breach. Unlike those courts that only look at reasonableness at the time of contracting (the "single look" approach), courts that look at reasonableness at the time of the breach (the "second look" approach) make it more difficult to obtain liquidated damages. Courts that follow the single look approach reason that their analysis reasonably focuses on the expectations of the parties at the time of their negotiations and reasonably reflects their expectations and the terms for which they bargained.

Some courts, however, find liquidated damages under any analysis to be non-compensatory and merely penalties. Those courts will not award liquidated damages, but, instead, will often go to extremes in their analysis to determine, if possible, the amount of compensatory damages. While some states by statute provide for the enforceability of liquidated damages, others specifically hold them not only unenforceable, but, in some circumstances, such as in franchise agreements, unfair and inequitable. Moreover, even in situations where liquidated damages may be awarded, there may be a difference as to which party has the burden to prove their enforceability or, in the alternative, prove they are not enforceable. This shift in burden is important to examine to know whether you need only defend your position or instead have the affirmative duty to prove your theory of recovery. The strategy and the likelihood of success under each approach are critical to analyze for any party facing or wishing to insert a liquidated damage provision in its contract.

Accordingly, when reviewing a contract or formulating a contract to be given to a vendor or other party in which you want (or wish to avoid) liquidated damages, particular consideration should be given to the jurisdiction of the court which will ultimately review a breach to determine the validity of a liquidated damage clause and the amount provided therein. In some instances, this review can be addressed by drafting the choice of law and/or choice of forum clause in a contract to provide the protection which you seek relative to liquidated damages provisions.

Liquidated damages can be a valuable weapon to use to preserve your investment and, in some instances, compell performance, where the other side may have otherwise, found it easier to breach and leave you with a sword, instead, over your head.

Al DeNapoli is a partner of the Boston-based law firm, Tarlow Breed Hart & Rodgers, P.C. Mr. DeNapoli is chairman of the firm's hospitality practice group and provides legal expertise on issues such as franchising, leasing and licensing to clients that range from nationally known chains to local restaurants and lodging businesses. Additionally, he concentrates a portion of his practice in the areas of civil litigation, including complex business issues that relate to contract and shareholder disputes, and employment problems. Realizing the importance of community and industry involvement, Mr. DeNapoli is affiliated with numerous boards and associations. In 2006, Mr. DeNapoli was elected as an editorial board member for the national publication, Hotel Business Review. He is a member of the Massachusetts Lodging Association and was recently named to the Massachusetts Restaurant Association board of directors. He can be contacted at 617-218-2024 or adenapoli@tbhr-law.com

back to top >

close window >