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"PROFIT" AND "RESALE" IN LIQUIDATED DAMAGE PROVISIONS

I've been representing hotels regarding event contract issues for a long time, and two of the most common misconceptions I hear are these:

- Liquidated damages clauses must be based on "profit."
- Liquidated damages must be reduced by resale or mitigation.

Both of these statements are simply not correct, and this article will explain why.

Introduction.

Lawyers spend three years in law school learning how to research, read, and understand the law, while most people involved in the hospitality industry have only basic legal training, if any. It's no wonder legal issues are intimidating and overwhelming to so many event professionals! As a result, people often rely on so called "industry experts" (non-lawyers) that give advice at seminars and in articles based on their experience and what they believe the law requires, usually based on something that they themselves were told long ago. This type of information often starts our wrong, and then gets misconstrued and misinterpreted as it is passed along. This article will to clarify what the law actually requires and will even provide you with the legal support for the explanation.

Usually when lawyers write a legal brief or letter, they include what are called "citations" in the body of the document. Citations are references to the legal authority that supports the position that the lawyer is taking. To someone who doesn't know what the citations mean or how to interpret them, it will seem like gobbeldy-gook. So, for the purposes of this article, I won't confuse you with citations. Rather, at the end of the article I will include not only the citation, but also quote the relevant portion of the statute, court case, or legal encyclopedia that is referenced[i]. The end notes don't contain citations from all fifty states, as that would make this prohibitively long, but there should be more than enough to illustrate what the law requires.

What are contract damages?

Damages are the amount of money that one party to a contract owes to the other party for failing to perform a contractual commitment, known as a "breach." The central purpose of damages is to provide fair compensation to the injured party, not to punish the breaching party. That is why in American law, "penalties" are not enforced. Many people in the meeting industry commonly use the term "penalty" when referring to contract damages, but that is technically not correct[ii]. If your contract uses the word "penalty" will that make the contract or clause invalid? Probably not, but it is a good idea to use the correct terms like "damages" or "liability" instead.

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How are damages determined?

If there is no damage provision in a contract, it means that the injured party will be awarded "actual" or "compensatory" damages (there are other types of damages, but they are beyond the scope of this article). This means that the injured party will be given the amount that puts the injured party in the position that it would have been in "but for the breach."

For example, A contracts to sell a car to B for $500 and later reneges on the deal. B has to buy a different car from C which costs $600. A must pay B $100 for breaching the contract, as that way B ends up having paid $500 to get a car as agreed in the original contract.

In the hotel industry, when a customer cancels or does not fully perform its event contract, the hotel may suffer a variety of damages, including lost revenues from guest rooms, food and beverage, audio/visual services, and many other expected revenues. A hotel may also suffer other indirect yet very real losses: the loss of the time, effort and expenses involved in negotiating the contract; incentive pay paid to the sales person for making the deal; costs of site visits; and then having to redirect its sales team to try to replace the lost business rather than selling future dates that have not already been sold. Figuring out these losses can be very complicated, so it is typical in hotel and event contracts for the parties to "pre-agree" on the damages that will be paid rather than trying to figure it out after the fact. This pre-agreement is called a "liquidated damage provision."

What are the legal requirements for liquidated damages?

The basic requirements of a liquidated damage provision are:

A. The parties agree that a party will be injured in the event the contract is breached;
B. They agree that the amount of loss will be difficult to determine;
C. Therefore, they agree at the time of contracting on an amount or formula that will be paid in the event of a breach that is a fair and reasonable estimate of the potential loss.

Some states adopt liquidated damages by statute[iii]. Others approve the use of liquidated damages through court cases, known as "common law[iv]".

Do liquidated damages have to be based on lost profit rather than revenue?

Contrary to what many people believe, liquidated damages do not have to be based on profit, and do not have to include the word "profit" in the clause. If you review the various legal authorities cited at the end of this article, **not one** states that liquidated damages must be based on "profit." All that is required is that the damages be a reasonable estimate of the expected loss that will be suffered.

There is a very obvious reason why profit is not required in a liquidated damage clause. The whole purpose of using the clause, as referenced by all the legal sources below, is that determination of the actual loss would be extremely difficult. In other words, if it were easy to figure out a hotel's lost profit in the event of a cancellation, there would be no reason to use a liquidated damage provision!

It is common for event industry professionals to insist that hotel profit is always something like 75% on guest rooms and 35% on banquet food and beverage. That ignores the fact that every

guest room sold and every food and beverage event held has a different profit margin. Yes, the hotel knows its total revenue and its total costs, and thus can calculate its overall profit, but that does not mean that the profit is the same for each individual or group.

Further, customers focus on guest rooms and food and beverage in event contracts and ignore that there are a wide range of other facilities and services that hotels provide that generate revenues that are lost in cancellation or non-performance, but are not accounted for if the damages are artificially limited to guests room or food and beverage profit.

When negotiating damage clauses, the focus should be on agreeing upon a reasonable amount of total compensation for non-performance or cancellation, rather than trying to limit damages to some inaccurate "profit" calculation.

- **Do liquidated damages have to give credit for resale?**

As stated above, if a contract does not have a liquidated damage clause and a breach occurs, the hotel will be awarded its actual damages. In that case, the hotel would have to give credit for rooms that are resold, often referred to as "mitigation." However, resale or mitigation credit is generally not required in a liquidated damage provision. As the United States Supreme Court explained when discussing liquidated damages back in 1907:

> …the courts became more tolerant of such provisions, and have now become strongly inclined to allow parties to make their own contracts, and to carry out their intentions, even when it would result in the recovery of an amount stated as liquidated damages, upon proof of the violation of the contract, and without proof of the damages actually sustained.[v]

In other words, in a liquidated damage provision, the parties agree at the time of contracting on the amount that will be paid, and proof of actual loss is not required. Many courts have followed the Supreme Court's approach, as do the legal encyclopedias.[vi]

That means that whether the hotel resells some, or all, or none of the cancelled rooms is usually irrelevant. That is because the amount due under the clause is supposed to be a reasonable estimate of the loss, and in order for that to occur, the parties had to consider not just what the hotel would lose if the event were cancelled, but also what the hotel might be able to make up by reselling. That is why hotel contracts typically have charts or scales of damages that require the payment of different amounts depending upon when the event cancels. The clause is attempting to estimate not just the loss, but also the potential to resell.

Customers often find it hard to accept that there no requirement for the hotel to reduce damages by resale, but they are overlooking that the damage clause already has built in that estimated resale. If for example an event represented $100,000 in guest room revenue but the damage clause only required the group to pay 40% of that amount for a cancellation at a certain point, that is reflecting that the hotel is estimating that it will make up the other 60% of the loss by reselling.

The many legal authorities below emphasize that liquidated damages provisions must be a reasonable attempt by the parties to estimate the loss that will be suffered in the event of a breach. If a customer believes that the damage percentage proposed by the hotel does not accurately consider potential resale, then it is better for the customer to suggest a different

percentage than to try to tack on "resale." But remember, just as the law generally does not allow the breaching party to get credit for mitigation, it also does not allow the non-breaching party to claim that the amount agreed upon in insufficient. If the parties agreed on only 30% damages, the hotel will not have a right to claim additional amounts from the customer if it turns out that the hotel does not resell 70% of the cancelled rooms. Both parties are taking a risk that the amount agreed upon might turn out to be too high, or too low, but in exchange for "liquidating" the damages they are avoiding the time, expense and uncertainty that would be involved in proving actual loss.

Summary

While there is a great deal of confusion and misinformation in the meeting industry about damage clauses, and while the law in every state is not completely uniform, it is clear that generally liquidated damage provisions do not have to be based on "profit" and that credit for resale or mitigation is not required. Given this knowledge, hopefully hotels and their customers will be able to work together to negotiate damage clauses that are reasonable and fair estimates that work for both sides without using "profit" and without adding a resale or mitigation requirement on top of the already compromised damage amounts.

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[i] NOTE: The quotes below have been edited for reading by non-lawyers, such as citations to other authorities within the quotes have been removed. Such edits did not change the context or meaning.

[ii] **Restatement (Second) of Contracts § 356 (1981)**

(NOTE: The Restatement is a type of encyclopedia created by legal scholars that summarizes the law.)

The central objective behind the system of contract remedies is compensatory, not punitive. Punishment of a promisor for having broken his promise has no justification on either economic or other grounds and a term providing such a penalty is unenforceable on grounds of public policy.

[iii] **Ca. Civil Code §1671(b)**
Except as provided in subdivision (c) (NOTE: the exceptions in (c) are not relevant to hotel contracts), a provision in a contract liquidating the damages for the breach of the contract is valid unless the party seeking to invalidate the provision establishes that the provision was unreasonable under the circumstances existing at the time the contract was made.

Ga. Code Ann., § 13-6-7
If the parties agree in their contract what the damages for a breach shall be, they are said to be liquidated and, unless the agreement violates some principle of law, the parties are bound thereby.

La. CC Art. 2005
Parties may stipulate the damages to be recovered in case of non-performance, defective performance, or delay in performance of an obligation. That stipulation gives rise to a secondary obligation for the purpose of enforcing the principle one.

Mt. Code Ann. §28-2-721.
When provision fixing liquidated damages valid. (1) Every contract by which the amount of damage to be paid or other compensation to be made for a breach of an obligation is determined in anticipation thereof is to that extent void, except as expressly provided in subsection (2).

(2) The parties to a contract may agree therein upon an amount which shall be presumed to be an amount of damage sustained by a breach thereof when, from the nature of the case, it would be impracticable or extremely difficult to fix the actual damage.

[iv] **Dobson Bay Club II DD, LLC v La Sonrisa De Siena, LLC**, 239 Ariz. 132 (Az. 2016).
The principal reason parties include liquidated damages provisions within contracts is to avoid proof and other calculation issues involved in litigating what a reasonable damage award would be in the event a breach occurs, especially when the amount in controversy is small. [references removed]. Whether a liquidated damages provision is enforceable depends upon the particular circumstances of each case. Arizona courts have generally followed the test described in the Restatement of Contracts to determine whether a contractual provision that establishes an amount of damages in advance is reasonable, and therefore enforceable. As explained… an agreement setting the amount of damages in advance of a breach is an unenforceable penalty unless (1) the amount fixed is a reasonable forecast of just compensation for harm caused by the breach, and (2) the harm caused is "incapable or very difficult of accurate estimation."

Butler v. Lembeck, 182 P.3d. 1185 (Co., 2007)
A contract provision for liquidated damages is invalid as a penalty if it is unreasonably large for the expected loss from a breach of contract. However, unless the contract on its face establishes that the stipulated liquidated damages are so disproportionate to any possible loss as to constitute a penalty, the determination of whether the specified damages constitute a penalty is a question of fact. To determine whether a liquidated damages provision constitutes a penalty, the court must consider: (1) whether the parties intended to liquidate damages; (2) whether the amount of liquidated damages, when viewed as of the time the contract was made, was a reasonable estimate of the presumed actual damages that the breach would cause; and (3) whether, when viewed again as of the date of the contract, it was difficult to ascertain the amount of actual damages that would result from a breach.

Red Sage v. DESPA 254 F.3d 1120 (D.C., 2001)
The parties to a contract may agree in advance to a sum certain which shall be forfeited as liquidated damages for breach of the contract without reference to the actual damages found at the time of the breach. But if such an agreement is for a penalty it is void. In order to determine whether or not the provision should be construed as a penalty the contract must be construed as a whole as of the date of its execution. If under the circumstances and expectations of the parties existing at the time of execution it appears that the provision is a reasonable protection against uncertain future litigation the provision will be enforced even though no actual damages were proved as of the date of the breach. If, on the other hand, it appears that the stipulation is designed to make the default of the party against whom it runs more profitable to the other party than performance would be, it will be void as a penalty.

Doc's Junkie Musick, Inc. v Active Alarms, 545 So.2d 500 (Fl., 1989)
Parties to a contract may stipulate as to what the consequences of a breach shall be and if the stipulation is reasonable, it will control and exclude all other consequences.. In deciding whether a liquidated damages clause is proper, a court should determine if the damages by their very nature were uncertain at the time of contracting and not excessive or unreasonable.

OWBR, LLC v. Clear Channel Communications, 266 F. Supp.2d 1214 (Hi., 2003)
Under Hawaii law, liquidated damages contained in a contract must be enforced if there is a "reasonable relation" between the liquidated damages and the amount of the party's actual damages. However, a liquidated damages clause that constitutes a penalty will not be enforced… According to the Restatement (Second) of Contracts § 356, two factors combine in determining whether an amount fixed as damages is so unreasonably large as to be a penalty. The first is the reasonableness of the liquidated damages amount in light of the anticipated or actual loss caused by the breach. The second is difficulty of proof of loss. The greater the difficulty either of proving that loss has occurred or of establishing its amount with the requisite certainty, ... the easier it is to show that the amount fixed is reasonable.

Penske Truck Leasing v. Chemetco, Inc. 725 N.E.2d 13 (Il., 2000)
Whether a contractual provision for damages is a valid liquidated-damages provision or a penalty clause is a question of law. There is no fixed rule applicable to all liquidated-damages agreements, and each one must be evaluated on its own facts and circumstances. The test for determining whether a liquidated-damages clause is valid as such or is void as a penalty is stated in section 356 of the Restatement (Second) of Contracts: "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."

Willard Packaging Co., Inc. v Javier, 169 Md.App. 109 (Md., 2006)
In most contract cases, the law of compensatory damages applies, providing a standard measure of compensation limited to the amount of injury incurred under a breach of the contract… The duty to keep a contract at common law means a prediction that you must pay damages if you do not keep it—and nothing else. Liquidated damages provisions, however, allow private parties to reform that fixed concept of injury providing relief in excess, or in lieu, of compensatory damages. [T]he fundamental purpose of a valid liquidated damages provision is to provide a reasonable measure of compensation in the event of a breach where, at the time the provision is agreed to the damages are indeterminable or will be otherwise difficult to prove.

NPS, LLC v. Minihane, 451 Mass. 417 (Ma., 2008)
It is well settled that a contract provision that clearly and reasonably establishes liquidated damages should be enforced, so long as it is not so disproportionate to anticipated damages as to constitute a penalty. A liquidated damages provision will usually be enforced, provided two criteria are satisfied: first, that at the time of contracting the actual damages flowing from a breach were difficult to ascertain; and second, that the sum agreed on as liquidated damages represents a reasonable forecast of damages expected to occur in the event of a breach.

Truck Rent-A-Center v. Puritan Farms 2nd, Inc., 361 N.E.2d 1015 (N.Y., 1977)
Liquidated damages constitute the compensation which, the parties have agreed, should be paid in order to satisfy any loss or injury flowing from a breach of their contract. In effect, a liquidated damage provision is an estimate, made by the parties at the time they enter into their agreement, of the extent of the injury that would be sustained as a result of breach of the agreement. Parties to a contract have the right to agree to such clauses, provided that the clause is neither unconscionable nor contrary to public policy. Provisions for liquidated damage have value in those situations where it would be difficult, if not actually impossible, to calculate the amount of actual damage. In such cases, the contracting parties may agree between themselves as to the amount of damages to be paid upon breach rather than leaving that amount to the calculation of a court or jury.

Phillips v Phillips, 820 S.W.2d 785 (Tx, 1992)
More recently, we restated the two-part Stewart test for determining whether to enforce a contractual damages provision as follows: "In order to enforce a liquidated damage clause, the court must find: (1) that the harm caused by the breach is incapable or difficult of estimation, and (2) that the amount of liquidated damages called for is a reasonable forecast of just compensation.

Lake Ridge Academy v Carney, 66 Ohio St.3d 376 (Ohio, 1993)
Where the parties have agreed on the amount of damages, ascertained by estimation and adjustment, and have expressed this agreement in clear and unambiguous terms, the amount so fixed should be treated as liquidated damages and not as a penalty, if the damages would be (1) uncertain as to amount and difficult of proof, and if (2) the contract as a whole is not so manifestly unconscionable, unreasonable, and disproportionate in amount as to justify the conclusion that it does not express the true intention of the parties, and if (3) the contract is consistent with the conclusion that it was the intention of the parties that damages in the amount stated should follow the breach thereof.

[v] **United States v. Bethlehem Steel Co.**, 205 U.S. 105, 119, 27 S.Ct. 450, 51 L.Ed. 731, (1907) (emphasis added).

[vi] **McCarthy v. Tally**, 297 P.2d 981 (Ca., 1956)
…no actual damage is necessary in order to recover under a liquidated damages provision provided that the case is, in other respects, a proper one under the conditions set forth in section 1671 of the Civil Code.

Red Sage v. DESPA 254 F.3d 1120 (D.C., 2001)
[T]he parties to a contract may agree in advance to a sum certain which shall be forfeited as liquidated damages for breach of the contract without reference to the actual damages found at the time of the breach.

Barrie School v Patch, 933 A.2d 382 (Md., 2007)
Liquidated damages differ fundamentally from mitigation of damages. While mitigation is part of a court's determination of actual damages that have resulted from a breach of contract, liquidated damages clauses are the remedy the parties to a contract have determined to be proper in the event of breach. Where the parties to a contract have included a reasonable sum that stipulates damages in the event of breach, that sum replaces any determination of actual loss.

Crown It Services, Inc. v Koval-Olsen, (N.Y., 2004)
Furthermore, where a contract contains a valid liquidated damages clause, mitigation is irrelevant.

Lake Ridge Academy v Carney, 66 Ohio St.3d 376 (Ohio, 1993)
A valid liquidated damages clause contemplates the nonbreaching party's inability to identify and mitigate its damages. If damages are "uncertain as to amount and difficult of proof," as they must be, the nonbreacher cannot be expected to reduce them after a breach.

34 A.L.R 1336
The majority of the cases hold that the amount stipulated in the contract as liquidated damages for a breach thereof, and which is regarded by the courts as liquidated damages, and not as a penalty, may be recovered in the event of a breach of the contract, even though no actual damages are suffered as a consequence of such breach' (listing cases from Arkansas, Florida, Illinois, Indiana, Iowa, Kansas, Kentucky, Maryland, Michigan, Minnesota, New York, Oregon, Pennsylvania, Texas, Washington, West Virginia and Canada). (Note: A.L.R. is a compendium of legal authorities)

Corbin, Contracts, § 1062, "A Valid Liquidation of Damages Makes Other Proof as to the Amount of Injury Unnecessary." (Note: Corbin is a legal encyclopedia)