Take a Second-Look at Liquidated Damages in Texas (Regardless of What the Texas Supreme Court Says)

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I. INTRODUCTION

The purpose of a liquidated damages clause in a contract is to allow the parties to agree in advance to the amount of compensation due one party in the event of the other party's breach.[1] Texas courts have long recognized the general enforceability of liquidated damage clauses.[2] These clauses have become routine in various types of contracts, including real estate sales contracts, construction contracts, and noncompetition agreements to name a few.[3] However, as always, the right of contracting parties to make their own bargains is not completely unlimited.[4] The fundamental goal of the law when it comes to contract damages is to redress breach by compensating the injured party, not to preemptively deter breach by compelling performance.[5] Therefore, courts will not enforce a liquidated damages provision deemed to function as a "penalty" intended only to secure the performance of the contract.[6]

The determination of whether a provision in a contract is an enforceable liquidated damages clause or an unenforceable penalty is a question of law

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[1] Garden Ridge, L.P. v. Advance Int'l, Inc., 403 S.W.3d 432, 438 (Tex. App.—Houston [14th Dist.] 2013, pet. denied).

[2] *See, e.g.*, Durst v. Swift, 11 Tex. 273, 282 (1854).

[3] 2 William V. Dorsaneo III, *Texas Litigation Guide* § 21.10[4][b] (2015).

[4] Phillips v. Phillips, 820 S.W.2d 785, 788 (Tex. 1991).

[5] 3 E. ALLAN FARNSWORTH, FARNSWORTH ON CONTRACTS § 12.18, at 301 (3d ed. 2004).

[6] *See* Roberts v. Dehn, 416 S.W.2d 851, 853 (Tex. Civ. App.—Dallas 1967, no writ).

for the courts to decide.[7] However, courts have often struggled with articulating and applying consistent standards in making this determination.[8] The distinction between a valid liquidated damages clause and an illegal penalty has been called one of the most subtle questions of the law,[9] leading one New York Court of Appeals judge to comment that "[t]he ablest judges have declared that they felt themselves embarrassed in ascertaining the principle on which the decisions . . . were founded."[10]

In many jurisdictions, older opinions often make reference to the "intention of the parties" as being the controlling factor.[11] However, commentators have noted these statements can be somewhat misleading.[12] For even in those early decisions, courts regularly acknowledged that "mere use of the term 'penalty,' or the term 'liquidated damages,' does not determine this intention, if, on the whole, the instrument discloses a different intent."[13] Thus, the decisions appear to have turned on some criteria other than simply what the parties intended as evidenced by the language in their contracts.[14]

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[7] Baker v. Int'l Record Syndicate, Inc., 812 S.W.2d 53, 55 (Tex. App.—Dallas 1991, no writ); Mayfield v. Hicks, 575 S.W.2d 571, 576 (Tex. Civ. App.—Dallas 1978, writ ref'd n.r.e.); Schepps v. Am. Dist. Tel. Co. of Tex., 286 S.W.2d 684, 690 (Tex. Civ. App.—Dallas 1955, no writ).

[8] Roy Ryden Anderson, *Liquidated Damages Under the Uniform Commercial Code*, 41 SW. L.J. 1083, 1085 (1988).

[9] Zucht v. Stewart Title Guar. Co., 207 S.W.2d 414, 418 (Tex. Civ. App.—San Antonio 1947, writ dism'd).

[10] Cotheal v. Talmage, 9 N.Y. 551, 553 (1854); *see also* Giesecke v. Cullerton, 117 N.E. 777, 778 (Ill. 1917) ("This court has said more than once that no branch of the law is involved in more obscurity by contradictory decisions than whether a sum specified in an agreement to secure performance will be treated as liquidated damages or a penalty . . . ."); Ferguson v. Ferguson, 110 S.W.2d 1016, 1018 (Tex. Civ. App.—Eastland 1937, no writ) ("Whether . . . a sum named in a contract to be paid by a party in default on its breach is to be considered liquidated damages or merely a penalty is one of the most difficult and perplexing inquiries encountered in the construction of written agreements.") (internal quotation marks omitted).

[11] *See, e.g.*, City of Indianola v. Gulf, W. Tex. & Pac. Ry., 56 Tex. 594, 606 (1882); Durst v. Swift, 11 Tex. 273, 281 (1854); Fessman v. Seeley, 30 S.W. 268, 269 (Tex. Civ. App.—San Antonio 1895, no writ).

[12] 24 SAMUEL WILLISTON & RICHARD A. LORD, A TREATISE ON THE LAW OF CONTRACTS § 65:11, at 274–75 (4th ed. 2002).

[13] Yetter v. Hudson, 57 Tex. 604, 613 (1882) (internal quotation marks omitted).

[14] *See* Comment, *Liquidated Damages and Penalties Under the Uniform Commercial Code and the Common Law: An Economic Analysis of Contract Damages*, 72 NW. U. L. REV. 1055, 1062 n.47 (1978) (quoting 11 JOSEPH M. PERILLO, CORBIN ON CONTRACTS § 58.5, at 426 (rev. ed. 2005) ("the intention of the parties is to control, as long as they have the right intention");

Underlying this purported "intention of the parties" analysis were often two criteria which have become the modern two-part test for analyzing liquidated damages clauses in almost every jurisdiction across the country.[15] The first prong of the test requires that the harm which could be expected to flow from a breach of the contract must be difficult or impossible to estimate.[16] The second requirement is that the amount stipulated as liquidated damages must be a reasonable estimate of just compensation.[17]

At first glance, these two criteria already appear at odds with one another: one based on uncertainty, the other reasonableness. Regarding the first prong, jurisdictions (including Texas) generally agree that the uncertainty of the damages must exist at the time the contract was negotiated and entered into.[18] The second element—often referred to as the more important analysis—is where jurisdictions have differed widely.[19] The reasonableness analysis raises questions such as "reasonable as compared to what?" and "determined as of when?"[20] How a court answers these questions generally places the jurisdiction into one of two camps: those taking a *pro*spective approach to the reasonableness analysis, and those taking a *retro*spective approach.[21]

Confusingly, Texas courts have at times used language that would seem to place it in both camps.[22] This Note will attempt to briefly describe the differences between the two approaches,[23] trace the history of Texas jurisprudence regarding the reasonableness analysis,[24] and shine a light on

Anderson, *supra* note 8, at 1086 ("Professor Corbin was quick to point out that this reasoning was wholly circular. In the context of liquidated damage provisions, 'intent of the parties' provided nothing more than a means for squaring doctrine with result.") (citations omitted).

[15] *See* WILLISTON & LORD, *supra* note 12, § 65:16, at 291–94; Anderson, *supra* note 8, at 1086.

[16] Polimera v. Chemtex Envtl. Lab., Inc., No. 09-10-00361-CV, 2011 Tex. App. LEXIS 3886, at *11 (Tex. App.—Beaumont May 19, 2011, no pet.).

[17] *Id.*

[18] Arthur's Garage, Inc. v. Racal-Chubb Sec. Sys., Inc., 997 S.W.2d 803, 810 (Tex. App.—Dallas 1999, no pet.); 11 JOSEPH M. PERILLO, CORBIN ON CONTRACTS § 58.11, at 459 (rev. ed. 2005); WILLISTON & LORD, *supra* note 12, § 65:15, at 290.

[19] *See* Comment, *supra* note 14, at 1065.

[20] WILLISTON & LORD, *supra* note 12, § 65:17, at 299.

[21] *See id.* at 302.

[22] *See infra* Part III.

[23] *See infra* Part II.

[24] *See infra* Part III.

what appears to be the current Texas approach as applied in the recent Texas Supreme Court decision of *FPL Energy LLC v. TXU Portfolio Management Company*.[25] As that case demonstrates, while Texas courts may use seemingly contradictory language to describe what it is they are doing with regard to the reasonableness analysis, in application their analysis is most consistent with a retroactive or "second-look" approach. Finally, this Note will offer a few basic drafting recommendations for increasing the likelihood that a liquidated damages provision will be enforced in Texas.

II. THE TWO APPROACHES FOR ASSESSING THE REASONABLENESS OF LIQUIDATED DAMAGES

As mentioned above, it is generally well-settled that the uncertainty of damages must be present at the time of contract formation.[26] Because few cases have hinged on the uncertainty element,[27] the reasonableness of the stipulated damages clause is often decisive. This section provides a basic discussion of the two approaches to the timing of the reasonableness analysis. The purpose is merely to explain the different approaches and their application, not to advocate for one approach over the other. The latter decision is left to the courts.

A. The "Single-Look" Approach

Traditionally, the reasonableness of a liquidated damages clause was judged at the time the contract was made, not the time at which a subsequent breach occurred.[28] This approach to reasonableness is sometimes called a "prospective" or "single-look" approach.[29] Courts using

[25] *See infra* Part IV.

[26] Oetting v. Flake Unif. & Linen Serv., Inc., 553 S.W.2d 793, 796 (Tex. Civ. App.—Fort Worth 1977, no writ); *see* Stewart v. Basey, 245 S.W.2d 484, 486 (Tex. 1952); *see also* Comment, *supra* note 14, at 1064. While it is worth noting that the uncertainty analysis is also susceptible to the same prospective/retrospective debate as the reasonableness analysis, there appears to be more agreement across jurisdictions that the damages must be difficult to estimate at the time of contract formation. Comment, *supra* note 14, at 1064. With that said, some commentators have suggested that courts are strongly affected by the facts as of the time of trial and that even for courts proclaiming a prospective approach "what counts is the convenience and efficiency by which actual damages can be measured *at trial*." *Id.* at 1065 (emphasis added).

[27] PERILLO, *supra* note 18, § 58.7, at 440.

[28] FARNSWORTH, *supra* note 5, § 12.18, at 305–06.

[29] WILLISTON & LORD, *supra* note 12, § 65:17, at 299–300.

this approach compare the amount of damages stipulated in the contract to the amount of damages that could have reasonably been foreseen or anticipated based solely on what the parties knew at the time of contract formation.[30] As one court applying this approach explained, "[t]he standard of measure here is not furnished by the plaintiff's actual loss or injury . . . but by loss or injury which might reasonably have been anticipated at the time the contract was made . . . . It is the look forward, and not backward, that we are called upon to take . . . ."[31] Under this approach, whether actual damages are greater or less than the amount stipulated in the contract is immaterial.[32] As long as the liquidated sum was a reasonable prediction of the potential damages—as judged at the time the contract was made—courts following this approach will generally enforce the liquidated damages provision.[33]

Courts applying the single-look approach phrase it in a variety of ways. One court has stated that the stipulated amount must bear "a reasonable relation to probable damages and . . . not [be] disproportionate to any damages reasonably to be anticipated."[34] Another has said that the amount in the liquidated damages clause must be a "reasonable estimate of the damages that would actually result if the contract were breached."[35] Regardless of the language used, the court will try to put itself in the same position the parties themselves were in when they were making the contract.[36]

A 1998 Massachusetts appellate court, in reviewing the enforceability of a liquidated damages provision, surveyed the law of every state to determine which test each state applied to the reasonableness analysis.[37] While noting that language and context made precise categorization

[30] *See id.* at 300.

[31] Banta v. Stamford Motor Co., 92 A. 665, 667 (Conn. 1914).

[32] *In re* Schaumburg Hotel Owner Ltd. P'ship, 97 B.R. 943, 953 (Bankr. N.D. Ill. 1989).

[33] Guiliano v. Cleo, Inc., 995 S.W.2d 88, 99 (Tenn. 1999); *see also In re* Schaumburg, 97 B.R. at 953 ("parties are not required to make the best estimation of damages, just one that is reasonable").

[34] Wandler v. Lewis, 567 N.W.2d 377, 382–83 (S.D. 1997).

[35] Lawyers Title Ins. Corp. v. Dearborn Title Corp., 939 F. Supp. 611, 616 (N.D. Ill. 1996), *aff'd in part, vacated in part on other grounds*, 118 F.3d 1157 (7th Cir. 1997).

[36] PERILLO, *supra* note 18, § 58.6, at 431; *see also* Honey Dew Assocs., Inc. v. M & K Food Corp., 241 F.3d 23, 28 n.3 (1st Cir. 2001) ("a judge, in determining the enforceability of a liquidated damages clause, should examine only the circumstances at contract formation") (internal quotation marks omitted).

[37] Kelly v. Marx, 694 N.E.2d 869 (Mass. App. Ct. 1998).

difficult, the court found that the single-look approach was most commonly applied, though only by a slight margin.[38] At that time, twenty-two states applied a single-look approach[39]; twenty applied a second-look approach[40]; three were controlled by a statute implicating neither approach[41]; and in the remaining states, the court was not able to discern the approach used.[42] Interestingly, the year after the appellate court in *Kelly v. Marx* espoused a second-look approach for the state of Massachusetts,[43] the Supreme Judicial Court of Massachusetts reversed course and adopted the single-look approach.[44] Federal courts also appear to apply the single-look test in cases involving federal government contracts.[45]

Courts following the single-look approach cite several advantages to this approach. The most commonly mentioned is the deference it gives to the bargain actually struck by the parties, or what some might call freedom of contract.[46] As Justice Holmes once said in reviewing the enforceability of a liquidated damages clause, "the proper course is to enforce contract[s] according to their plain meaning, and not to undertake to be wiser than the parties . . . ."[47] In testing the validity of a liquidated damages clause only at the time of contracting, the single-look approach arguably "most accurately matches the expectations of the parties, who negotiated a liquidated damage amount that was fair to each side based on their unique concerns and circumstances surrounding the agreement, and their individual estimate of

[38] *See id.* at 873–74.

[39] *Id.* at 873.

[40] *Id.* at 874; *see infra* Part II.B for a discussion of the "second-look" approach.

[41] *Kelly*, 694 N.E.2d at 874.

[42] *Id.*

[43] *Id.* at 870.

[44] Kelly v. Marx, 705 N.E.2d 1114, 1116 (Mass. 1999) ("The question before us is whether [the] enforceability of a liquidated damages clause is to be tested by analyzing the circumstances at contract formation, the prospective or 'single look' approach, or when the breach occurs, the retrospective or 'second look' approach. . . . We agree . . . that a judge, in determining the enforceability of a liquidated damages clause, should examine only the circumstances at contract formation.").

[45] *See* K-Con Bldg. Sys., Inc. v. United States, 97 Fed. Cl. 41, 50 (2011).

[46] *See Kelly*, 694 N.E.2d at 870; Guiliano v. Cleo, Inc., 995 S.W.2d 88, 100 (Tenn. 1999) ("Generally, the parties to a contract are free to agree upon liquidated damages and upon other terms that may not seem desirable or pleasant to outside observers. In that respect, courts should not interfere in the contract, but should carry out the intentions of the parties and the terms bargained for in the contract, unless those terms violate public policy.") (citations omitted).

[47] Guerin v. Stacey, 56 N.E. 892, 892 (Mass. 1900).

damages in event of a breach."[48] Related to the idea of freedom of contract, the single-look approach also provides a level of certainty to the parties regarding their potential liability on the contract.[49] Another advantage is that it saves courts, juries, parties, and witnesses the time and expense of having to litigate actual damages after a breach has occurred.[50] Furthermore, courts have noted that in a great number of cases the parties themselves are more intimately acquainted with the peculiar circumstances of the contract or the subject matter of the transaction and are therefore better able to compute the probable damages than are courts or juries.[51] In this sense, the courts recognize the estimate of damages made by the parties themselves "as being the best and most certain mode of ascertaining the actual damage, or what sum will amount to a just compensation."[52]

The obvious downfall of the single-look approach is the potential windfall it can create if, in the event of breach, actual damages turn out to be much less than a stipulated amount deemed reasonable at the time of contracting.[53] While such disparity may call into question the initial reasonableness of the pre-estimate in the first place, assuming the amount stipulated *was* reasonable at the time of contracting, a court employing a strict single-look approach would enforce the liquidated damages provision.[54]

The most taxing scenario for the single-look approach is the rare but extreme case where there are no actual damages at all.[55] Some courts stick firmly to the single-look approach and enforce a liquidated damages provision even in light of a subsequent lack of actual damages, the only question being whether the stipulated sum was reasonable when the contract was made.[56] This view weighs the practical advantages of

[48] *Kelly*, 705 N.E.2d at 1117.

[49] *Guiliano*, 995 S.W.2d at 100.

[50] PERILLO, *supra* note 18, § 58.7, at 438.

[51] Jaquith v. Hudson, 5 Mich. 123, 137 (1858).

[52] *Id.* at 137–38. For a good article advocating the use of the "single-look" approach, see Dennis R. LaFiura & David S. Sager, *Liquidated Damages Provisions and the Case for Routine Enforcement*, 20 FRANCHISE L.J. 175 (2001).

[53] *Kelly*, 705 N.E.2d at 1117.

[54] *See In re* Schaumburg Hotel Owner Ltd. P'ship, 97 B.R. 943, 953 (Bankr. N.D. Ill. 1989).

[55] FARNSWORTH, *supra* note 5, § 12.18, at 307.

[56] *See* Sw. Eng'g Co. v. United States, 341 F.2d 998, 1003 (8th Cir. 1965) ("It is not unfair to hold the contractor performing the work to such agreement if by reason of later developments damages prove to be less or nonexistent.").

upholding a forecast that was reasonable at the time of contracting over the disadvantages of allowing a party who has sustained no actual losses to recover damages.[57] Other single-look jurisdictions, however, have recognized the distastefulness of such strict adherence and have drawn a somewhat arbitrary line between cases in which there are no actual damages and those in which actual damages simply turn out to be less than anticipated.[58]

B. The "Second-Look" Approach

The other prevailing method for assessing the reasonableness of a liquidated damages provision compares the stipulated sum in the contract not only to the amount of damages that could reasonably be anticipated at the time of contract formation, but also to the amount of actual damages caused by a subsequent breach of the contract.[59] This addition of a retrospective analysis from the moment in time of contract breach is often characterized as the "second-look" approach.[60] The second-look approach is in many ways simply the opposite of the single-look approach. Whereas evidence of actual damages is irrelevant in a true single-look jurisdiction,[61] courts applying a second-look approach will strike down a liquidated damages provision as an unenforceable penalty if the stipulated sum greatly exceeds the amount of actual damages that later result from a breach.[62] In that case, the plaintiff's recovery is limited to the actual damages sustained and proven.[63] As one court concisely described the process of applying the second-look analysis:

> [O]ne must first judge whether the provision was a reasonable *estimate* of difficult-to-ascertain damage at the time the parties agreed to it. If it was a reasonable *estimate*, one must then conduct a retrospective appraisal of [the] liquidated damages provision. . . . If the actual damages turn out to be easily ascertainable, a court must consider whether the stipulated sum is unreasonably and grossly

[57] FARNSWORTH, *supra* note 5, § 12.18, at 307.

[58] *Id.* at 307–08.

[59] Guiliano v. Cleo, Inc., 995 S.W.2d 88, 99 (Tenn. 1999).

[60] FARNSWORTH, *supra* note 5, § 12.18, at 306.

[61] *See, e.g.*, Frick Co. v. Rubel Corp., 62 F.2d 765, 768 (2d Cir. 1933).

[62] *Guiliano*, 995 S.W.2d at 99.

[63] *Id.*

> disproportionate to the real damages from a breach . . . . If so, the liquidated damages provision will be deemed unenforceable as a penalty, and the court will award the aggrieved party no more than his actual damages.[64]

Thus, even in a case where the stipulated sum was freely negotiated by the parties and was a reasonable pre-estimate of damages when viewed from the moment of contract formation, under a second-look approach, the provision will not be enforced if actual damages turn out to be substantially lower than the stipulated amount.[65]

Courts adopting the second-look approach often cite to the Uniform Commercial Code and the Restatement (Second) of Contracts for support,[66] both of which are discussed below regarding their application to Texas law.[67] While sometimes referred to as the more "modern" test, [68] as of the 1998 Massachusetts case of *Kelly v. Marx* mentioned above, the second-look approach was slightly less common than the single-look approach.[69]

The advantages and disadvantages of the second-look approach are largely just the flip-side to those of the single-look approach. The main advantage of the second-look approach is that it prevents the windfalls in favor of the non-breaching party that the single-look approach allows, particularly in cases where there are no actual damages at all.[70] This arguably makes the approach more consistent with the basic principles of contract law—that the aggrieved party should be fully compensated for their losses but that penalty clauses should not be enforced.[71] The biggest criticism of the second-look approach is that it interferes with the parties' freedom of contract and undermines the certainty they have in their bargains, thus defeating the purpose of stipulating to damages in the first place.[72]

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[64] Shallow Brook Assocs. v. Dube, 599 A.2d 132, 137 (N.H. 1991) (second emphasis added) (citations omitted) (internal quotation marks omitted).

[65] *Id.*

[66] WILLISTON & LORD, *supra* note 12, § 65:17, at 302–04.

[67] *See infra*, Part III.B.

[68] PERILLO, *supra* note 18, § 58.6, at 431.

[69] Kelly v. Marx, 694 N.E.2d 869, 873–74 (Mass. App. Ct. 1998).

[70] *See* Kelly v. Marx, 705 N.E.2d 1114, 1117 (Mass. 1999).

[71] *See* Anderson, *supra* note 8, at 1088.

[72] *See* Guiliano v. Cleo, Inc., 995 S.W.2d 88, 100 (Tenn. 1999).

III. HISTORY OF TEXAS JURISPRUDENCE REGARDING THE REASONABLENESS ELEMENT

Putting a finger on Texas's approach to the reasonableness analysis seems like it should be as easy as simply placing it in either the single-look or the double-look camp.[73] However, a look at the case law reveals that the Texas approach has been less than clear. Different courts have, at times, said different things regarding the appropriate time for assessing the reasonableness of a liquidated damages provision.[74]

Two early Texas cases illustrate the confusion that has plagued the Texas courts on this issue. *Eakin v. Scott*[75] and *Collier v. Betterton*[76] were decided relatively close in time—only seven years apart—and written by the same Texas Supreme Court Justice but have been cited as supporting opposite interpretations of the reasonableness analysis. *Eakin* is an 1888 decision written by Justice Gaines.[77] The case involved a contract for the sale and delivery of cattle from Scott to Eakin for $50,000.[78] The contract called for the first payment of $8,000 to be made by Eakin within sixty days.[79] The contract also included a liquidated damages clause by which Eakin agreed "that the above amount [$8,000] shall act as a forfeiture in the event I shall abandon said trade."[80] Eakin subsequently breached the contract but refused to pay the $8,000, so Scott sued to recover the stipulated amount.[81] The court in *Eakin* acknowledged that its decision depended "upon the question whether the stipulation for the forfeiture of the $8,000 note is to be treated as an agreement for liquidated damages, or as a mere penalty to recover such damages as the plaintiffs should actually

[73] Indeed, in 1998, the Massachusetts appellate court seemed to have no trouble labeling Texas a "double-look" jurisdiction. *Kelly*, 694 N.E.2d at 874.

[74] *See* Presnal v. TLL Energy Corp., 788 S.W.2d 123, 123 (Tex. App.—Houston [1st Dist.] 1990, writ denied) ("We find that the decisions of the various courts of civil appeals in this state upon this question . . . are hopelessly irreconcilable, and after as full an investigation as we have been able to make of the holdings by our Supreme Court[,] the correct rule to be announced in this case is in considerable doubt . . . .") (quoting Bourland v. Huffhines, 244 S.W. 847, 849 (Tex. Civ. App.—Amarillo 1992, writ dism'd w.o.j.)).

[75] 7 S.W. 777 (Tex. 1888).

[76] 29 S.W. 467 (Tex. 1895).

[77] *Eakin*, 7 S.W. at 777–78.

[78] *Id.* at 778.

[79] *Id.*

[80] *Id.*

[81] *Id.*

sustain."[82] Although it was agreed by both sides that no actual damages accrued to Scott as a result of Eakin's breach, the court upheld the liquidated damages clause "without reference to the actual damages sustained."[83]

Seven years later, Justice Gaines—now Chief Justice of Texas Supreme Court—wrote the decision in another liquidated damages case, however, this time he sang a different tune.[84] The *Collier* case involved a contract to build a house.[85] The contract provided that if Betterton, the contractor, did not complete construction by October 1, he agreed to pay Collier, the owner, $10 per day for every day thereafter that completion was delayed.[86] Betterton missed the deadline, and Collier was not able to move into the house until November 12.[87] Collier sought liquidated damages for the forty-two days he was delayed in taking possession.[88] Although the liquidated damages award of $10 per day was ultimately upheld, in its rationale the court stated that "[i]f the supposed stipulation greatly exceed the actual loss, if there be no approximation between them, and this be made to appear by the evidence, then, it seems to us, and then only, should the actual damages be the measure of the recovery."[89] Because Betterton had provided no evidence of the amount of actual damages suffered by Collier, the liquidated damages provision was sustained,[90] and thus the result in *Collier* does not appear all that different from the result in *Eakin*. However, the *Collier* court's reference to the comparison of actual damages to a stipulated amount represents a marked difference from Justice Gaines's prior holding in *Eakin* that a liquidated damages provision agreed to by the parties should be enforced "without reference to the actual damages sustained."[91]

[82] *Id.*

[83] *Id.* at 778–79.

[84] Collier v. Betterton, 29 S.W. 467, 467–68 (Tex. 1895).

[85] *Id.*

[86] *Id.* So called "delay" clauses for liquidated damages are common in construction contracts. *See, e.g.*, Commercial Union Ins. Co. v. La Villa Indep. Sch. Dist., 779 S.W.2d 102, 106 (Tex. App.—Corpus Christi 1989, no writ); Loggins Constr. Co. v. Stephen F. Austin State Univ. Bd. of Regents, 543 S.W.2d 682, 683 (Tex. Civ. App.—Tyler 1976, writ ref'd n.r.e.).

[87] *Collier*, 29 S.W. at 468.

[88] *Id.*

[89] *Id.*

[90] *Id.*

[91] Eakin v. Scott, 7 S.W. 777, 779 (Tex. 1888).

The *Eakin* case appears to have fixed the time for testing the reasonableness of a liquidated damages provision at the time the contract was entered into, disregarding the actual loss sustained.[92] The *Collier* case, on the other hand, held that a liquidated damages provision is only valid so long as there is an approximation between the amount stipulated and the damages actually suffered.[93] In the years following these decisions, Texas courts appeared to endorse one approach or the other based on a desire to either to sustain or strike down the liquidated damages provision in question.[94] This was the state of the law in 1952 when the Texas Supreme Court decided *Stewart v. Basey*,[95] which became—and remains—the style case on liquidated damages in Texas.

A. Stewart v. Basey and the Common Law Test for Liquidated Damages in Texas.

Stewart v. Basey is often cited as establishing the common law test for liquidated damages in Texas.[96] The case involved the breach of a lease contract containing a liquidated damages clause.[97] The lease was for a five-year term, and the rent was $325 per month.[98] A liquidated damages clause

[92] Carl G. Mueller, Jr., Comment, *A Functional Approach in Determining the Validity of a Liquidated-Damages Clause*, 30 TEX. L. REV. 752, 756 (1952).

[93] *Id.*

[94] *Id.*; *see, e.g.*, Pippin Bros. v. Thompson, 292 S.W. 618, 620 (Tex. Civ. App.—Waco 1927, writ dism'd w.o.j.) ("Does the amount of damages it can reasonably be inferred the parties had in contemplation *at the time of the execution of the contract* . . . bear some reasonable proportion to the amount stipulated?") (emphasis added); Norman v. Vickery, 128 S.W. 452, 453 (Tex. Civ. App.—Dallas 1910, writ ref'd) ("The question is: What did the parties intend *at the time the contract was made*?") (emphasis added); Whitcomb v. City of Hous., 130 S.W. 215, 218 (Tex. Civ. App.—San Antonio 1910, writ ref'd) (invalidating a liquidated damages clause because the city sustained no actual damages); Cowart v. Walter Connally & Co., 108 S.W. 973, 975 (Tex. Civ. App.—Texarkana 1908, no writ) (holding that the rule announced in *Collier* is "a later expression of the views of the Supreme Court, and we think a better interpretation of the law").

[95] 245 S.W.2d 484 (Tex. 1952).

[96] *See, e.g.*, Presnal v. TLL Energy Corp., 788 S.W.2d 123, 125 (Tex. App.—Houston [1st Dist.] 1990, writ denied); Cmty. Dev. Serv., Inc. v. Replacement Parts Mfg., Inc., 679 S.W.2d 721, 726 (Tex. App.—Houston [1st Dist.] 1984, no writ); Bethel v. Butler Drilling Co., 635 S.W.2d 834, 838 (Tex. App.—Houston [14th Dist.] 1982, writ ref'd n.r.e.); U.S. Leasing Corp. v. Smith, 555 S.W.2d 766, 770 (Tex. Civ. App.—Tyler 1977, writ ref'd n.r.e.); 2 William V. Dorsaneo III, *Texas Litigation Guide* § 21.10[4][b] (2015).

[97] *Stewart*, 245 S.W.2d at 485.

[98] *Id.*

provided that if the lessee failed to make rental payments when due *or breached any other term of the lease*, the lease would terminate and the lessee would owe liquidated damages of $150 per month for the remaining months of the unexpired term.[99] Eleven months into the lease, the lessee vacated the premises and returned his keys to the lessor.[100] The lessor was able to re-let the premises to other tenants—thus negating any actual damages—but still sought liquidated damages from the breaching tenant in the amount of $150 per month for the remaining months of the original five-year term.[101]

The Texas Supreme Court rightly identified the controlling question in the case as "whether the language . . . stipulating the damages recoverable for the breach of a lease contract is a provision for liquidated damages or for a penalty."[102] The court noted that "[v]olumes have been written on the question,"[103] and it acknowledged the inconsistent judicial decisions on the issue.[104] In its attempt to reconcile these conflicting lines of authority, the court handed down what became generally recognized as the common law test for liquidated damages in Texas: "All agree that to be enforceable as liquidated damages the damages must be uncertain and the stipulation must be reasonable."[105] In formulating this test, the court relied on language from the Restatement (First) of Contracts,[106] which provided that:

> (1) An agreement, made in advance of breach, fixing the damages therefor, is not enforceable as a contract and does not affect the damages recoverable for the breach, unless (a) the amount so fixed is a reasonable forecast of just compensation for the harm that is caused by the breach, and (b) the harm that is caused by the breach is one that is incapable or very difficult of accurate estimation.[107]

Ultimately, the court held that the liquidated damages provision in the lease was not a reasonable forecast of damages because it "provided the

[99] *Id.*
[100] *Id.*
[101] *Id.*
[102] *Id.*
[103] *Id.*
[104] *Id.* at 485–86.
[105] *Id.* at 486.
[106] *Id.*
[107] RESTATEMENT (FIRST) OF CONTRACTS § 339 (AM. LAW INST. 1932).

same reparation for the breach of each and every covenant" without regard for the varying degrees of importance of the different covenants within the lease.[108] Though often credited with establishing the common law test for liquidated damages in Texas, *Stewart* says nothing about when the reasonableness of a liquidated damages provision is judged or to what extent actual damages are relevant to that determination.

The court did note that "the true test of uncertainty" is "that the damages were very uncertain in the contemplation of the parties when the contract was executed."[109] One commentator writing soon after the *Stewart* decision believed this language answered the question for the reasonableness prong as well,[110] and a court of appeals decision just a few years later seemed to support this belief.[111] Texas's adoption of the Uniform Commercial Code's (UCC) treatment of liquidated damages a decade later, however, would seem to cast doubt on this interpretation, at least as far as transactions under the Code are concerned.

B. The Uniform Commercial Code and the "Anticipated or Actual Harm" Test

The enactment of Article 2 of the UCC in Texas in 1967 represented a significant departure from the common law test of *Stewart* for contracts involving the sale of goods. Section 2-718(1) of the Uniform Commercial Code, adopted in Texas as Section 2.718(a) of the Texas Business and Commerce Code,[112] provides that:

> Damages for breach by either party may be liquidated in the agreement but only at an amount which is reasonable in light of the anticipated or actual harm caused by the breach,

[108] *Stewart*, 245 S.W.2d at 486–87.

[109] *Id.* at 486.

[110] *See* Mueller, *supra* note 92, at 756 n.21 ("Although the court stated the time in terms of judging uncertainty, it is clear on a reading of the entire opinion that the same time would apply to the determination of reasonableness.").

[111] *See* Schepps v. Am. Dist. Tel. Co. of Tex., 286 S.W.2d 684, 690 (Tex. Civ. App.—Dallas 1955, no writ) ("Generally, the question of whether a sum named in a contract . . . is to be considered as liquidated damages, or merely as a penalty, is . . . to be determined as of the time when the contract was executed. The viewpoint of the parties at the time when the contract was made, and not the situation which is shown to have existed when it was breached, is to be considered in determining the issue as to reasonableness of the stipulation or certainty as to actual damages.") (citations omitted) (internal quotation marks omitted).

[112] TEX. BUS. & COM. CODE ANN. § 2.718(a) (West 2009).

> the difficulties of proof of loss, and the inconvenience or non-feasibility of otherwise obtaining an adequate remedy. A term fixing unreasonably large liquidated damages is void as a penalty.[113]

While seemingly incorporating both the uncertainty and reasonableness prongs of the common law test, the most significant change is the UCC's specific inclusion of "actual damages" in the determination of reasonableness. Thus, the "anticipated or actual harm" test would appear, at least at first glance, to be most consistent with a second-look approach. As some commentators have pointed out, however, the "anticipated or actual harm" language is actually subject to multiple interpretations.[114]

There is no debating that the UCC makes actual damages now relevant to the reasonableness determination in contracts for the sale of goods. The question is what role actual damages should play. Does the "anticipated or actual harm" language require that a liquidated damages provision be reasonable when compared with *either* anticipated *or* actual harm?[115] Or should the "or" be read as an "and," and thus a stipulated amount must be reasonable when compared to both anticipated *and* actual damages?[116]

When the test is read literally—in the disjunctive in which it was written—a liquidated damages provision need only be reasonable when compared to one or the other of anticipated harm *or* actual harm.[117] As applied by one court approving of this interpretation, anticipated harm and actual harm would be treated as two alternative means for validating a liquidated damages provision.[118]

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[113] U.C.C. § 2-718(1) (AM. LAW INST. & UNIF. LAW COMM'N 2011).

[114] *See, e.g.*, Comment, *supra* note 14, at 1070; Anderson, *supra* note 8, at 1099; Margaret L. Hussey, Comment, *Liquidated Damages: A New Rule for Texas Under the Uniform Commercial Code?*, 32 BAYLOR L. REV. 123, 128 (1980).

[115] *See* Comment, *supra* note 14, at 1070–71.

[116] *Id.*

[117] *See* Anderson, *supra* note 8, at 1093–94.

[118] Equitable Lumber Corp. v. IPA Land Dev. Corp., 344 N.E.2d 391, 395 (N.Y. 1976) ("a liquidated damages provision will be valid if reasonable with respect to [e]ither (1) the harm which the parties anticipate will result from the breach at the time of contracting or (2) the actual damages suffered by the nondefaulting party at the time of [the] breach"); *see also* Cal. & Hawaiian Sugar Co. v. Sun Ship, Inc., 794 F.2d 1433, 1436 (9th Cir. 1986), *amended by* 811 F.2d 1264 (9th Cir. 1987) ("The choice of the disjunctive appears to be deliberate."); Anderson, *supra* note 8, at 1098 ("Although section 2-718 does refer to actual harm, the reference is in the disjunctive and, therefore, can be read to exclude evidence of actual harm if the clause is found to

A second interpretation of the UCC's "anticipated or actual harm" language is more in line with a second-look approach to reasonableness, where a provision that appeared reasonable at the moment of contract formation—i.e. in relation to "anticipated harm"—could still be held to be an unenforceable penalty if it is not also reasonable when compared with the actual harm that resulted from a breach.[119] It is somewhat misleading to characterize this interpretation as requiring that the stipulated amount be reasonable when compared to *both* anticipated and actual harm because there would be no practical reason for invalidating a liquidated damages clause that accurately approximates actual damages but not anticipated harm.[120] Therefore, in practice, this approach only cares whether the stipulated amount is reasonable when compared to actual damages, which reflects a true second-look approach to reasonableness.

Another question raised by the language of the UCC is what effect to give the last sentence of Section 2-718(1), which states: "A term fixing unreasonably large liquidated damages is void as a penalty."[121] This sentence can be read as either placing an additional restriction on liquidated damages, or as merely explaining the consequence for failing to satisfy the "anticipated or actual harm" analysis in the first sentence.[122] New York appears to be the lone state interpreting this sentence as a separate test to be applied independently of the criteria in the first sentence of Section 2-718(1).[123] This sentence is more accurately read as merely clarifying the penalty imposed once a liquidated amount is found to be unreasonable under the "anticipated or actual harm" test of the first sentence.[124] Indeed, reading the last sentence as an additional test by which a liquidated

be reasonable in terms of the anticipated loss."); Hussey, *supra* note 114, at 128 ("if at either time the stipulation is reasonable, the provision will be enforced as liquidated damages").

[119] *See* Anderson, *supra* note 8, at 1099.

[120] *Id.* ("there would be no sense in striking down such a clause, because that would leave the court in a position requiring it to determine damages under usual legal tests, which would bring it to the same dollar amount as the liquidated clause").

[121] U.C.C. § 2-718(1) (AM. LAW INST. & UNIF. LAW COMM'N 2011); TEX. BUS. & COM. CODE ANN. § 2.718(a) (West 2009).

[122] Hussey, *supra* note 114, at 128.

[123] *See, e.g.*, N. Bloom & Son (Antiques) Ltd. v. Skelly, 673 F. Supp. 1260, 1268 (S.D.N.Y. 1987) ("The second sentence of § 2-718(1) is held to constitute a separate test . . . ."); *Equitable Lumber*, 344 N.E.2d at 395 ("Having satisfied the test set forth in the first part of subdivision (1) of section 2-718, a liquidated damages provision may nonetheless be invalidated under the last sentence of the section if it is so unreasonably large that it serves as a penalty . . . .").

[124] *See* Hussey, *supra* note 114, at 128; *see also* Anderson, *supra* note 8, at 1105–06.

damages clause could be invalidated would only seem plausible under the second-look approach described above; for if a stipulated damages provision could satisfy the "*either/or*" test based on its reasonable relation to anticipated damages only to be struck down by the last sentence of Section 2-718(1) for being "unreasonably large," it would seem to invalidate the "*either/or*" interpretation of the test altogether.[125] Interestingly, this sentence was completely removed from Section 2-718(1) when Article 2 of the UCC was revised in 2003.[126] However, because no state chose to adopt the 2003 amendments, they were withdrawn from the Code in 2011,[127] and thus the sentence remains in Section 2-718(1).

1. The "Equivocation" of the Restatement (Second) of Contracts

Section 356 of the Restatement (Second) of Contracts, published in 1981, was drafted to "harmonize with Uniform Commercial Code Section 2-718(1),"[128] and provides the following:

> 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.[129]

Upon initial inspection, the language of the Restatement (Second) appears to track very closely to the UCC. The Restatement echoes the "anticipated or actual" harm test of the UCC—though it replaces "harm" with "loss"—and, indeed, the Restatement (Second) is often cited as persuasive authority in support of a second-look approach to reasonableness.[130]

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[125] *See* Anderson, *supra* note 8, at 1106. Paradoxically, this is exactly what the New York Court of Appeals did in *Equitable Lumber* when it held that a liquidated damages provision could satisfy the first sentence of § 2-718(1) and yet still be struck down for being "unreasonably large" per the second sentence. 344 N.E.2d at 395–97.

[126] U.C.C. § 2-718(1) (as amended in 2003). The reasons provided in the Official Comments were that it was unnecessary, misleading, and redundant. *Id.* cmt. 3.

[127] U.C.C. Forward to Official Text and Comments (2011).

[128] RESTATEMENT (SECOND) OF CONTRACTS § 356 reporter's note (AM. LAW INST. 1981).

[129] *Id.* § 356(1).

[130] PERILLO, *supra* note 18, § 58.6, at 434–36; WILLISTON & LORD, *supra* note 12, § 65:16, at 291–92, § 65:17, at 302–03.

However, in the comments to Section 356, the Restatement provides the following: "Furthermore, the amount fixed is reasonable to the extent that it approximates the loss anticipated at the time of the making of the contract, even though it may not approximate the actual loss."[131] The comment then directs the reader to the following illustration:

> A contracts to build a grandstand for B's race track for $1,000,000 by a specified date and to pay $1,000 a day for every day's delay in completing it. A delays completion for ten days. If $1,000 is not unreasonable in light of the anticipated loss and the actual loss to B is difficult to prove, A's promise is not a term providing for a penalty and its enforcement is not precluded on grounds of public policy.[132]

This comment and illustration seem surprisingly to reflect a single-look approach to reasonableness.

The next illustration uses the same fact pattern as the previous illustration but changes it slightly to address the situation in which there are no actual damages:

> The facts being otherwise as stated in [the previous illustration], B is delayed for a month in obtaining permission to operate his race track so that it is certain that A's delay of ten days caused him no loss at all. Since the actual loss to B is not difficult to prove, A's promise is a term providing for a penalty and is unenforceable on grounds of public policy.[133]

The situation *not* addressed by the Restatement, however, is the one that falls just between these two illustrations—the one in which the liquidated damages provision is reasonable when compared to anticipated damages but where actual damages can be readily proven to be much lower than the amount stipulated.[134] Thus, as one commentator noted, the Restatement "equivocates" on the most difficult liquidated damages situation.[135]

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[131] RESTATEMENT (SECOND) OF CONTRACTS § 356 cmt. b (AM. LAW INST. 1981).

[132] *Id.* § 356 cmt. b, illus. 3.

[133] *Id.* § 356 cmt. b, illus. 4.

[134] Anderson, *supra* note 8, at 1093.

[135] *Id.*

C. Post-UCC Caselaw in Texas

The additional confusion created by the "anticipated or actual harm" language in the UCC—and repeated in the Restatement (Second) of Contracts—has not been lost on Texas courts.[136] The question of whether Texas follows the traditional single-look or the modern second-look approach to reasonableness has continued to stymie the intermediate appellate courts,[137] and cases citing both approaches can still be found since the enactment of the UCC in Texas.[138] Adding to the confusion, a new breed of cases sprang up in the wake of the UCC and the Restatement in which the courts use language that would seem to support both approaches within a single decision. The following two cases represent this post-UCC trend.

1. Muddying the Water

The facts of *Baker v. International Record Syndicate*[139] are good facts for a liquidated damages clause. Baker was a photographer hired by International Record Syndicate to photograph a little-known musical

[136] *See* Garden Ridge, L.P. v. Advance Int'l, Inc., 403 S.W.3d 432, 438–40 (Tex. App.—Houston [14th Dist.] 2013, pet. denied); Baker v. Int'l Record Syndicate, Inc., 812 S.W.2d 53 (Tex. App.—Dallas 1991, no writ).

[137] To be fair, the federal courts have not fared much better at nailing down the Texas approach. *See, e.g.*, Advance Tank & Constr. Co. v. City of DeSoto, 737 F. Supp. 383, 385 (N.D. Tex. 1990) (citing *Stewart v. Basey* for the proposition that "a liquidated damages provision is to be considered in light of the circumstances as the parties perceived them at the formation of the contract, and not as they exist when the contract was performed (or breached) and the damages occurred"). *But see* Thanksgiving Tower Partners v. Anros Thanksgiving Partners, 64 F.3d 227, 232 (5th Cir. 1995) (stating that under Texas law "liquidated damages must not be disproportionate to actual damages as measured at the time of the breach" and that "if the liquidated damages are disproportionate to the actual damages, the clause will not be enforced and recovery will be limited to the actual damages proven").

[138] *See, e.g.,* Nexstar Broad., Inc. v. Gray, No. 09-07-364 CV, 2008 WL 2521967, at *3 (Tex. App.—Beaumont June 26, 2008, no pet.) ("Evidence that the harm caused is difficult to estimate, and that the amount of liquidated damages is a reasonable forecast, must be viewed as of the time the parties executed the contract."); Murphy v. Cintas Corp., 923 S.W.2d 663, 666-67 (Tex. App.—Tyler 1996, writ denied) (holding a liquidated damages provision to be enforceable even though actual damages were readily calculable at the time of trial); Guido & Guido, Inc. v. Culberson Cty., 459 S.W.2d 674, 678 (Tex. Civ. App.—El Paso 1970, writ ref'd n.r.e.) ("The amount of actual damages is relevant to the issue of whether the stipulation for damages is reasonable, for it must be so in order to be enforced and must bear a reasonable relationship to the actual damages contemplated or, in fact, suffered as a result of the breach.").

[139] *Baker*, 812 S.W.2d at 53.

group.[140] Baker mailed thirty-seven negatives to the record company, but when the negatives were returned to Baker they had holes punched in them.[141] The contract between Baker and the record company provided for liquidated damages of up to $1,500 per photograph if any photographs were lost or damaged by the record company.[142] On appeal, the court noted that Baker had presented evidence at trial of the wide range he had been paid for similar photographs in the past,[143] demonstrating both the difficulty of estimating the true value of the photographs as well as the reasonableness of the $1,500 per photograph estimate.[144] Therefore, based on the band's unknown potential for fame at the time, the inherent difficulty of valuing a piece of art in general, and the broad range of values and long-term earning power of photographs, the court found that $1,500 per photograph was not an unreasonable estimate of damages.[145]

The result in *Baker* seems to be the correct one. This was clearly a situation where the actual damages that could be expected to flow from a breach of the contract would be very difficult to determine at the time of contracting, and there was evidence presented at trial to support the $1,500 per photograph estimate. But the confusing aspect of *Baker* is not in the result; it is in the reasoning—or rather the language—employed by the court in reaching the result.

After quoting the UCC rule, as codified in the Texas Business and Commerce Code,[146] the court restated the rule using the language of the two-part, common law test of *Stewart*.[147] The court noted this rule "might be termed the 'anticipated harm' test."[148] Even more definitively, the court explicitly stated that "[e]vidence related to the difficulty of estimation and the reasonable forecast must be viewed *as of the time the contract was*

[140] *Id.* at 54–55.

[141] *Id.*

[142] *Id.*

[143] *Id.* at 55 (noting he had made as little as $125 and as much as $1,500 off of a single photograph).

[144] *Id.* at 55–56.

[145] *Id.* at 55.

[146] *Id.*; *see supra*, Part III.B.

[147] *Baker*, 812 S.W.2d at 55 ("Under Texas law, a liquidated damages provision will be enforced when the court finds (1) the harm caused by the breach is incapable or difficult of estimation, and (2) the amount of liquidated damages is a reasonable forecast of just compensation.").

[148] *Id.*

executed."[149] Only a few lines later, however, the court provided that "[a]ditionally, liquidated damages must not be disproportionate to actual damages," and that "[i]f the liquidated damages are shown to be disproportionate to the actual damages, then the liquidated damages can be declared a penalty and recovery limited to actual damages proven."[150] This, the court noted, "might be called the 'actual harm' test."[151]

Ultimately, the court's intermingling of prospective (single-look) language with retrospective (second-look) language did not affect the result in that case because, on these facts, the actual damages were just as difficult to determine at the time of trial as they had been at the time of contracting.[152] The question not answered by these facts is the same question on which the Restatement "equivocates": what if the estimate was reasonable at the time of contracting but actual damages have become susceptible to calculation by the time of trial and are much less than the stipulated amount?

2. Preparing a Path to the Texas Supreme Court

A recent case out of the Fourteenth Court of Appeals in Houston looked squarely at the relationship between the common law and statutory tests for liquidated damages and decided that they are, in fact, the same test and that both are consistent with a second-look approach to reasonableness.[153] The *Garden Ridge* case involved the retail housewares chain, Garden Ridge, and one of its vendors, Advance.[154] Garden Ridge placed an order with Advance for 4,450 inflatable snowmen of different sizes, which it planned to sell during the holiday season.[155] Shortly before putting the snowmen out for sale, Garden Ridge realized that some of the snowmen in the shipment did not conform to the purchase order it had submitted to Advance.[156] Garden Ridge decided to sell the snowmen anyway but then charged back to Advance the entire purchase price for all of the snowmen pursuant to a

[149] *Id.* (emphasis added).

[150] *Id.*

[151] *Id.*

[152] *Id.* at 55–56.

[153] Garden Ridge, L.P. v. Advance Int'l, Inc., 403 S.W.3d 432, 438–40 (Tex.App.—Houston [14th Dist.] 2013, pet. denied).

[154] *Id.* at 435.

[155] *Id.*

[156] *Id.*

liquidated damages clause in its vendor contract addressing "unauthorized substitution" of merchandise.[157] At trial, Garden Ridge did not establish any amount of actual damages from Advance's noncompliance with the purchase order.[158]

Reviewing whether the liquidated damages provision in the vendor contract was enforceable, the appellate court first noted that the UCC test and the common law test for liquidated damages "reflect the same essential factors and the same type of reasonableness test."[159] The court equated the first clause of § 2.718(a) (requiring that the liquidated damages be "reasonable in light of the anticipated or actual harm caused by the breach") with the common law requirement that liquidated damages be a "reasonable forecast of just compensation."[160] It equated the second and third clauses of § 2.718(a) (regarding "the difficulties of proof of loss") with the common law requirement "that the harm caused by the breach is incapable or difficult of estimation."[161]

Having established that the tests are the same, the court turned to Garden Ridge's argument for an "ex ante" reasonableness analysis.[162] While acknowledging that language in *Baker* would seem to support Garden Ridge's single-look theory, the court went on to hold that unreasonableness can be established by showing that actual damages are much less than the amount stipulated in the contract.[163] Thus, basing its decision on the explicit reference to "actual harm" in the UCC, the court applied a second-look approach and found that the liquidated damages clause was unenforceable because there were no actual damages.[164]

A concurring opinion, however, argued that the statutory rule is actually different from and thus supersedes the common law rule in contracts for the sale of goods.[165] The concurring judge felt the majority's interpretation of the UCC's language—specifically the word "or"—strained the plain

[157] *Id.* at 435–36.

[158] *Id.* at 436.

[159] *Id.* at 439.

[160] *Id.* at 438.

[161] *Id.*

[162] *Id.* at 439 ("That is, if, *at the time the contract is formed*, actual damages are difficult to estimate and the amount specified in the contract is a reasonable forecast of just compensation, a liquidated damages term is enforceable.") (emphasis added).

[163] *Id*. at 440.

[164] *Id.*

[165] *Id.* at 447 (Frost, J., concurring) (citation omitted).

meaning of the statute and undermined the freedom of contract.[166] Following the "*either/or*" interpretation of the UCC discussed above,[167] the judge argued that "a liquidated-damages provision may be reasonable based upon *either* anticipated harm *or* actual harm caused by the breach."[168] Thus, the party asserting penalty should have to show "unreasonableness under *both* anticipated harm *and* actual harm caused by the breach."[169] This judge noted "there are now three different and conflicting views on this question from the three intermediate appellate courts that have addressed this issue,"[170] but expressed hope that the Texas Supreme Court would clarify Texas's position in one of the cases in which the court had recently granted review.[171] That case was *FPL Energy LLC v. TXU Portfolio Management Co.*,[172] discussed below.

IV. THE TEXAS SUPREME COURT "CLARIFIES" ITS POSITION ON REASONABLENESS

As noted in the concurrence to *Garden Ridge*, the *TXU* case provided the Texas Supreme Court with an opportunity to settle once and for all the question of whether Texas is a single-look or a second-look jurisdiction.[173]

A. Facts

The facts of the case are somewhat complicated. The case involves a liquidated damages provision in a contract for the production of electricity and renewable energy credits.[174] The plaintiff, TXU, was a retail electricity provider distributing electricity directly to consumers.[175] Beginning in 1999, Texas energy providers, like TXU, were required to purchase a certain portion of the electricity they distribute from renewable sources.[176] At the same time, the legislature also created a renewable energy credit

[166] *Id.* at 448–49.
[167] *See supra*, Part III.B.
[168] *Garden Ridge*, 403 S.W.3d at 448 (Frost, J., concurring).
[169] *Id.*
[170] *Id.* at 450.
[171] *Id.*
[172] 426 S.W.3d 59 (Tex. 2014).
[173] *Garden Ridge*, 403 S.W.3d at 450 (Frost, J., concurring).
[174] *TXU*, 426 S.W.3d at 60–61.
[175] *Id.* at 61.
[176] *Id.*

(REC) trading program, whereby distributors like TXU could purchase RECs in lieu of purchasing actual capacity from renewable sources.[177] One REC represents one megawatt hour of energy produced from renewable sources.[178] The producers of renewable energy, therefore, can sell both the actual renewable energy produced, as well as the RECs created by that production.[179]

FPL was a renewable energy production company operating several windfarms.[180] In 2000, TXU contracted with FPL to purchase renewable electric energy, as well as the RECs generated from the production of that energy, in order to meet TXU's statutory renewable energy requirements.[181] In the event that FPL failed to meet its obligations under the contract, the contract provided for liquidated damages of $50 per REC not produced.[182] This $50 per REC figure was tied to the penalty TXU would be assessed by the Texas Public Utilities Commission for failing to meet its REC requirement.[183] The contract also provided that if the Public Utilities Commission ever removed or amended the $50 per REC penalty, the liquidated damages under the contract would be equal to the lesser of (1) the amended penalty or (2) twice the annual average market price per REC as determined by the Public Utilities Commission.[184] For several years, FPL failed to provide the agreed upon amount of renewable energy and RECs to TXU.[185]

B. Procedure

TXU sued FPL for breach of contract and sought liquidated damages for FPL's failure to provide the agreed upon RECs and electricity.[186] The trial court refused to enforce the liquidated damages provision because TXU was able to cover by obtaining substitute electricity elsewhere and because it determined that the stipulated amount of $50 per REC was not a realistic

[177] *Id.*
[178] *Id.*
[179] *Id.*
[180] *Id.*
[181] *Id.*
[182] *Id.* at 66.
[183] *Id.*
[184] *Id.*
[185] *Id.* at 62.
[186] *Id.*

forecast of damages.[187] The court of appeals, however, held that the liquidated damages provision *was* enforceable because the damages were difficult to estimate and the $50 per REC was a reasonable estimate of just compensation; thus, it assessed damages at $29 million based on a deficiency of 580,000 RECs and a deficiency rate of $50 per REC.[188]

C. Analysis

For reasons not related to this Note, the Texas Supreme Court held, as a preliminary matter, that the liquidated damages provision could be applied only, if at all, to REC deficiencies (not failure to deliver actual renewable electricity capacity), and only to those REC deficiencies not excused by lack of transmission capacity or curtailment orders from the Electricity Reliability Council of Texas.[189] Thus, the appellate court's damages assessment of $29 million was immediately cut down to a possible $11 million based on a 220,000 REC deficiency that was determined to be directly attributable to FPL.[190]

The court then considered the enforceability of the liquidated damages provision with regard to those 220,000 RECs.[191] After affirming that "[t]he basic principle underlying contract damages is compensation for losses sustained and no more," the court restated the "two indispensable findings a court must make to enforce contractual damages provisions: (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."[192] Next, the court paid lip service to the traditional, single-look approach by stating: "We evaluate both prongs of this test from the perspective of the parties at the time of contracting."[193] And then, like so

[187] *Id.*

[188] *Id.* at 62, 71–72.

[189] *Id.* at 67–68.

[190] *See id.* at 71–72.

[191] *Id.* at 72.

[192] *Id.* at 69 (internal quotation marks omitted).

[193] *Id.* at 69–70 (citing Polimera v. Chemtex Envtl. Lab, Inc., No. 09-10-00361-CV, 2011 Tex. App. LEXIS 3886, at *11–12 (Tex. App.—Beaumont May 19, 2011, no pet.); Baker v. Int'l Record Syndicate, Inc., 812 S.W.2d 53, 55 (Tex. App.—Dallas 1991, no writ); Mayfield v. Hicks, 575 S.W.2d 571, 576 (Tex. Civ. App.—Dallas 1978, writ ref'd n.r.e.); Muller v. Light, 538 S.W.2d 487, 488 (Tex. Civ. App.—Austin 1976, writ ref'd n.r.e.); Schepps v. Am. Dist. Tel. Co. of Tex., 286 S.W.2d 684, 690 (Tex. Civ. App.—Dallas 1955, no writ); Zucht v. Stewart Title

many courts before it, in the very next sentence the court stated that "a liquidated damages provision may be unreasonable because the actual damages incurred were much less than the amount contracted for."[194]

Regarding the first element of the test for liquidated damages, the court agreed with TXU that damages for failure to provide the agreed upon RECs were difficult to estimate at the time of contract formation.[195] The court reached this conclusion based on the uncertain market for RECs at the time of contracting.[196] The statutory scheme was passed in 1999; at the time of contracting in 2000, the market for RECs did not yet exist.[197]

Moving on to the second element of the test, the court addressed what it termed the "unbridgeable discrepancy" between the liquidated damages provision as written and the "unfortunate reality in application."[198] The liquidated damages provision as written provided for liquidated damages of $50 per REC, or if the statutory penalty applicable to TXU were ever amended, then the lesser of (1) the amended amount or (2) twice the annual average market price per REC as determined by the Public Utilities Commission.[199] Because the statutory penalty had not been amended, and because the Public Utilities Commission had not issued a determination of the average annual market price per REC, applying the liquidated damages provision as written would have resulted in liquidated damages of $50 per REC.[200] The court, however, ignoring the language which required the determination of market value to come from the Public Utilities Commission, stated that "[t]he contracts . . . anticipate that the amount of damages may be tied to market value, rather than an arbitrary number."[201] Although the Public Utilities Commission had expressly denied TXU's request to issue a determination of the annual average market price per REC, the court noted that the actual market value of a REC during the period in question ranged from $4 to $14.[202] Thus, the court indicated that

Guar. Co., 207 S.W.2d 414, 418 (Tex. Civ. App.—San Antonio 1947, writ dism'd); RESTATEMENT (SECOND) OF CONTRACTS § 356 cmt. b (AM. LAW INST. 1981)).

[194] *TXU,* 426 S.W.3d at 70. (internal quotation marks omitted).

[195] *Id.*

[196] *Id.*

[197] *Id.*

[198] *Id.* at 72.

[199] *Id.*

[200] *Id.*

[201] *Id.* at 71.

[202] *Id.* at 72.

the appropriate amount of damages should be between $8 and $28 per REC, "depending on what the PUC would have determined as the actual market value of a REC in each year."[203] This would have placed TXU's damages somewhere between $1,760,000 and $6,160,000.[204]

Ultimately, because the court found that actual damages, whatever they might have been found to be by the Public Utilities Commission, would have been less than the stipulated amount of $50 per REC, the court held that the liquidated damages clause was an unenforceable penalty.[205] While the court noted that the law does not "create a broad power to retroactively invalidate liquidated damages provisions that appear reasonable as written," it stated that the forecast of damages in this case "was flawed by its reliance on events that did not and perhaps [could not] occur."[206]

D. Implications of TXU

1. What the Texas Supreme Court Held

Whatever its language in getting there, the Texas Supreme Court appears to have interpreted the common law test for liquidated damages to apply a second-look approach to reasonableness, one in which actual damages can retrospectively invalidate a provision even if that provision was reasonable when viewed from the moment of contract formation.[207]

2. What the Texas Supreme Court Did Not Hold

Contrary to what it may appear, the Texas Supreme Court did not address the question before the court in *Garden Ridge* regarding whether the language of the UCC should be interpreted to require only that liquidated damages be reasonable when compared to *either* anticipated *or* actual harm. The Texas Supreme Court, noticeably, did not mention the UCC in its holding in *TXU* because the UCC is only applicable to transactions in "goods,"[208] and the transmission of electrical power has previously been determined by the court not to be a "good" for purposes of

[203] *Id.*

[204] *See id.*

[205] *Id.*

[206] *Id.* (referring to a Public Utilities Commission determination of the market value of RECs during the applicable period).

[207] *See id.*

[208] U.C.C. §§ 2-102 & 2-105 (AM. LAW INST. & UNIF. LAW COMM'N 2011).

the UCC.[209] Until this specific question is addressed by the Texas Supreme Court, it is still an open question; however, based on the results of *Baker* and *Garden Ridge*, and by analogy the court's application of a second-look approach under the common law test in *TXU*, it seems safe to assume that the court would likely place emphasis on actual damages in cases under the UCC as well.

V. DRAFTING RECOMMENDATIONS

As the saying goes, hindsight is twenty-twenty. Or, in the context of liquidated damages, what was reasonable at one point in time may have become unreasonable in retrospect. Thus, it seems that even the most carefully drafted liquidated damages provision may be invalidated as a penalty if actual damages wind up being less than was reasonably anticipated at the time of contracting. There is no precise formula by which to determine when liquidated damages become disproportionate to the actual damages[210]; therefore, the best one can do is try to make sure liquidated damages are reasonable at the time of contracting. With that said, what follows are some general recommendations for drafting liquidated damages clauses in Texas.

A. Call It "Liquidated Damages"

Courts have routinely held that merely designating a clause in a contract as "liquidated damages" will not prevent the courts from holding that it is in fact a penalty, and vice versa. [211] However, there is no sense in inviting controversy.[212] Therefore, when drafting a liquidated damages provision, avoid using the term "penalty," and instead specifically refer to the provision as "liquidated damages."

[209] Navarro Cty. Elec. Coop., Inc. v. Prince, 640 S.W.2d 398, 400 (Tex. App.—Waco 1982, no writ).

[210] S. Union Co. v. CSG Sys., Inc., NO. 03-04-00172-CV, 2005 Tex. App. LEXIS 564, at *17–18 (Tex. App.—Austin Jan. 27, 2005, no pet.).

[211] Chan v. Montebello Dev. Co., No. 14-06-00936-CV, 2008 WL 2986379, at *3 (Tex. App.—Houston [14th Dist.] July 31, 2008, pet. denied).

[212] FARNSWORTH, *supra* note 5, § 12.18, at 319.

B. Include Explicit "Recitals"

It may be beneficial to include explicit recitals in the contract acknowledging that "actual damages are uncertain and would be difficult of ascertainment," and that both parties agree the stipulated sum "constitutes reasonable compensation in the event of a breach."[213] One example, in the context of a contract for the sale of real estate, might include the following:

> The parties to this contract agree that the Seller's actual damages, in the event of a default by the Purchaser, would be difficult of definite ascertainment because of the uncertainties of the real estate market and the fluctuations of property values between the date of this contract and the date of breach, and because of differences of opinion with respect thereto, and the parties therefore agree that such amount is, as to each of them, reasonable as liquidated damages.[214]

Parties may also want to clearly express that the stipulated sum is intended as "liquidated damages and not as a penalty," and that it is meant to be "compensatory" rather than "punitive."[215]

Finally, it may be wise to recite a nonexhaustive list of the general categories of losses which are intended to be compensated by the liquidated damages clause.[216] If nothing else, this may serve as evidence of the types of damages that were "anticipated" by the parties at the moment of contract formation. It also has the added benefit of providing evidence of foreseeability for consequential damages in the event that liquidated damages are not enforced.[217]

C. Avoid "Shotgun" Clauses

Courts have historically invalidated liquidated damages clauses that prescribe the same amount of liquidated damages for breaches of varying degrees of importance.[218] This type of clause is sometimes referred to as a

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[213] 10 *Texas Transaction Guide* § 55.293[1][a] (Kendrick et al. eds., 1991).

[214] *Id.* at § 55.293[2].

[215] *Id.* at § 55.293[1][a].

[216] FARNSWORTH, *supra* note 5, § 12.18a, at 320.

[217] *Id.*

[218] *See, e.g.*, Stewart v. Basey, 245 S.W.2d 484, 486–87 (Tex. 1952).

"shotgun" or "blunderbuss" clause.[219] Instead, liquidated damages clauses should be drafted narrowly so that the stipulated sum relates to a particular, specific type of breach.[220] Alternatively, a clause in which damages are graduated based on some formula or criteria that take into account the potential for the varying degrees of seriousness of the breach may be more likely to be enforced.[221]

D. Avoid "Multiples" of Actual Damages

Liquidated damages clauses providing for some multiple of actual damages have been held to be illegal as a matter of law in Texas.[222] The definitive case on this is the Texas Supreme Court case of *Phillips v. Phillips*, in which a partnership agreement between ex-spouses provided for liquidated damages of ten times actual damages in the event of a breach of the partnership agreement.[223]

E. Avoid "Damages-Plus" Clauses

Similar to the "multiples" clauses mentioned above, parties should never draft a liquidated damages clause that attempts to allow the aggrieved party to collect some level of liquidated damages *in addition to* actual damages.[224] This sort of clause has been described as attempting to allow the aggrieved party to "have his cake and eat it too,"[225] and such a clause could never logically be supported as being a reasonable forecast of damages.[226]

F. Consider a Choice of Law Provision

A drafter in a second-look jurisdiction wishing to take advantage of the certainty the single-look approach provides may wish to include a choice of law provision directing that the relationship between the parties be controlled by the law of a state following the single-look approach to

[219] FARNSWORTH, *supra* note 5, § 12.18a, at 319.

[220] Anderson, *supra* note 8, at 1110.

[221] *Id.* at 1109–10; FARNSWORTH, *supra* note 5, § 12.18a, at 319.

[222] Phillips v. Phillips, 820 S.W.2d 785, 789 (Tex. 1991).

[223] *Id.* at 786–87.

[224] Anderson, *supra* note 8, at 1110.

[225] *Id.*

[226] FARNSWORTH, *supra* note 5, § 12.18a, at 319.

reasonableness. Note, however, that the forum state may still choose not to apply the law of the chosen state, notwithstanding the choice of law provision, if doing so would violate the public policy of the forum state.[227]

G. Consider a Bonus for Early Performance as an Alternative to Liquidated Damages.

An alternative to a liquidated damages clause may be to offer a bonus or premium for early performance.[228] For example, where a $1,000 per day penalty for delayed performance may be unenforceable, moving the completion date in the contract to 10 days later but then offering a $1,000 per day bonus for each day the work is finished early may be allowable.[229] Obviously, adjustments for deadlines and contract price must be taken into consideration. While this sort of clause may still be subject to the same penalty analysis as a liquidated damages provision, courts may be understandably hesitant about where to draw the line in this area.[230]

H. Other Considerations

Given the second-look approach applied by the Texas Supreme Court in *TXU*, it may go without saying that a forecast of damages has a better chance of being viewed as reasonable if there is, in fact, *some* level of actual damages proven.[231] Plaintiffs with no actual damages have lost the ability in Texas to hide behind a liquidated damages clause that appeared reasonable at the outset. Even actual damages that are smaller than expected stand a better chance of being reasonable compared to a stipulated amount than *no* damages at all. Thus, if a defendant can prove, or if a plaintiff concedes, that no actual damages occurred, even a reasonable pre-estimate will likely not be enforced. Note the difference between a lack of actual damages and a situation in which actual damages exist but remain incapable or very difficult to quantify after a breach, as was the case in *Baker*.[232] On a related note, there is some support for the idea that the more difficult it

[227] Gator Apple, LLC v. Apple Tex. Rests., Inc., 442 S.W.3d 521, 532 (Tex. App.—Dallas 2014, pet. filed).

[228] FARNSWORTH, *supra* note 5, § 12.18, at 315.

[229] *Id.*

[230] *Id.*

[231] FPL Energy, LLC v. TXU Portfolio Mgmt. Co., 426 S.W.3d 59, 70 (Tex. 2014).

[232] Baker v. Int'l Record Syndicate, Inc., 812 S.W.2d 53, 55 (Tex. App.—Dallas 1991, no writ).

would be to estimate damages, the more lenient a court might be in assessing the reasonableness of the estimation.[233]

VI. CONCLUSIONS

In stating that reasonableness is assessed "from the perspective of the parties at the time of contracting" but then striking down the liquidated damages provision as an unenforceable penalty based on the "unbridgeable discrepancy between [the provision] as written and the unfortunate reality in application," the Texas Supreme Court in *TXU* appears to have fallen into the familiar trap of talking out of both sides of its mouth when it comes to the reasonableness of liquidated damages.[234] While its decision did little to alleviate the confusing language courts have used in dealing with this issue, one thing it appears the court did resolve is that Texas follows the second-look approach to the reasonableness analysis.[235] This is likely to be better news for defendants than for plaintiffs because it gives defendants an "ace in the hole" of avoiding onerous liquidated damages provisions by proving that actual damages were less than the amount stipulated in the contract.

The adoption of the UCC in Texas for contracts involving the sale of goods further convoluted what was already a confusing issue.[236] While the court's decision in *TXU* did not specifically address contracts under the UCC, it seems likely that a similar retrospective approach, in which more emphasis is placed on actual damages than what the parties may have decided amongst themselves was reasonable at the moment of contracting, would be applied in that context as well.

Though there are certainly cases that would appear to point to the contrary, this may have been the Texas position as far back as *Collier v. Betterton* in 1895.[237] Whatever the case, it seems to be the Texas position now.[238] Thus, practitioners should always be cognizant of the fact that any liquidated damages clause, however reasonable it may seem at the outset, will be subject to a second-look in light of the actual damages sustained. Though this approach may detract from the confidence parties have that courts will enforce their mutual bargains, it helps assure that illegal

[233] Wassenaar v. Panos, 331 N.W.2d 357, 363 (Wis. 1983).

[234] *TXU*, 426 S.W.3d at 70–72.

[235] *See id.* at 72.

[236] Anderson, *supra* note 8, at 1091.

[237] 29 S.W. 467, 468 (Tex. 1895).

[238] *See generally TXU*, 426 S.W.3d at 72.

penalties cannot be dressed up as liquidated damages clauses. The most practitioners can do now in drafting a liquidated damages clause is try to make it appear as reasonable as possible at the time of contracting. But as to whether it will actually be enforced or not, as one blogger recently wrote in response to the *TXU* case, you may need to "get out your crystal ball."[239]

[239] Jason Johns, *Negotiating a Liquidated Damages Clause in Texas? Get Out Your Crystal Ball*, CLIMATE POLICY, RENEWABLE ENERGY, & SUSTAINABILITY BLOG (March 21, 2014), http://www.lawofrenewableenergy.com/2014/03/articles/renewable/negotiating-a-liquidated-damages-clause-in-texas-get-out-your-crystal-ball/.