

# Liquidated Damages Clauses

## How Do They Work?

Rusty Adams  
May 31, 2022

Publication 2351



**L**iquidated damages clauses are common in contracts dealing with Texas real estate. They are found in most sales contracts, whether residential, commercial, farm and ranch, or unimproved. They are found in many construction contracts.

Really, a liquidated damages clause may be included in most any contract if the parties agree. Such provisions can provide advantages to the parties. However, they are not always enforceable by the courts.

### What are Liquidated Damages?

Liquidated, in the legal sense, means that a debt or dollar amount is settled or determined, especially by agreement. If damages are unliquidated, that means they cannot be determined by a fixed formula and, instead, must be determined in some other way—usually by a judge or jury based on evidence presented at a trial. So “liquidated damages” means damages that are easily ascertained (e.g., in a suit on an account or a promissory note) or whose amount is fixed by agreement of the

### Takeaway

Liquidated damages clauses are common in Texas real estate contracts, and they are generally enforceable. However, courts will not uphold the enforcement of a penalty.

parties to the transaction (e.g., in a liquidated damages clause).

In a liquidated damages clause, the parties to a contract stipulate in advance that in the event of a breach, the breaching party will pay the nonbreaching party a fixed amount of money representing the loss sustained from the breach. Generally speaking, liquidated damages clauses are enforceable. As long as the agreement is enforceable, this provision furnishes the measure of damages for the breach.

The most common place for a liquidated damages clause involves the seller’s receiving of the earnest money as

liquidated damages for the buyer's default. It is common to see liquidated damages clauses in construction contracts, setting forth a specific amount of damages for each day completion is delayed past a deadline.

## Advantages of Liquidated Damages Provisions

Agreeing to liquidated damages clauses carries several advantages.

First, generally speaking, they allow the contracting parties to negotiate in advance amounts that the parties believe are fair based on the circumstances and the parties' expectations at the time the contract is made.

Second, they provide certainty, at least to some extent, of what the parties' potential liability or recourse will be.

Third, they can allow the parties to simplify their court cases or, better yet, avoid them altogether, saving or reducing the time and expense of litigation. Often in litigation, the biggest issue is determining the amount of damages, and the parties spend significant time, money, and effort preparing evidence of damages to present at trial. Instead of dealing with these things in a courtroom after the fact, the parties simply agree to an amount they consider just compensation.

Of course, "the best laid schemes o' mice an' men gang aft agley." Courts are supposed to uphold the freedom of contract, and ordinarily they give great deference to the agreement of the contracting parties. Courts like to say they cannot and will not rewrite contracts to relieve a party from a bad deal, but that is not necessarily so. Courts sometimes make exceptions to that rule, and liquidated damages clauses undergo judicial scrutiny.

## Are Liquidated Damages Clauses Enforceable?

As stated before, the parties to a contract agree at the time of contracting that the liquidated clause supplies the measure of damages. However, these clauses may be challenged in court. Is such an agreement enforceable? Generally, yes. But as with so many other questions in law, the answer is, "It is until it's not."

The reason for this lies in the theoretical underpinnings of contractual damages. Contract damages are generally supposed to compensate the injured party for losses actually incurred. They are not intended to discourage a party from breaching a contract, to compel a party to perform its promises, or to punish a party for breaching. For this reason, liquidated damages clauses that estimate

in advance a party's just compensation for another party's breach are considered valid, while those that are designed to secure a party's performance or punish a party's nonperformance are considered unenforceable penalties.

Courts generally interpret and enforce contracts based on the intent of the parties as determined by examining the actual language of the contract, giving the words their plain meaning, in most cases. The entire contract is considered as a whole. The use of the terms "liquidated damages" or "penalty" may be considered in determining intent but is not conclusive.

The assertion that a liquidated damages clause is an unenforceable penalty is considered an affirmative defense and, as such, the party attempting to avoid enforcement must plead and prove that it is unenforceable. Whether a liquidated damages clause is enforceable or not is a question of law to be decided by a judge.

The general rule for determining enforceability was announced in *Stewart v. Basey*, 150 Tex. 666, 245 S.W.2d 484 (1952). To be enforceable, the clause must meet two requirements. First, the amount must be a reasonable forecast of just compensation for the damages caused by the breach. Second, the damages must be impossible or difficult to estimate accurately. Both prongs of the test are to be evaluated from the perspective of the parties at the time of making the contract. There is no formula for determining the reasonableness of the amount. It appears to be entirely at the whim of the court. The court may consider mitigation of damages in its reasonableness analysis.

Over the years, different courts in various jurisdictions have struggled with the reasonableness of the liquidated damages amount and whether it should be evaluated from the perspective of the contracting parties or by comparing the estimate to the actual harm after the fact.

The Texas Supreme Court essentially announced a new requirement in *FPL Energy, LLC v. TXU Portfolio Mgmt. Co., L.P.*, 426 S.W.3d 59 (Tex. 2014). The court stated the rule that evaluation of reasonableness is made from the perspective of the parties when entering the contract. Nevertheless, in evaluating the reasonableness of the damage forecast, the court observed an "unacceptable disparity" and "unbridgeable discrepancy" between the amount of damages estimated and agreed on in the clause and the "unfortunate reality in application." Thus, the court held the provision unenforceable. The Supreme Court restated this rule in *Atrium Med. Ctr., LP*

*v. Houston Red C LLC*, 595 S.W.3d 188 (Tex. 2020), and this requirement appears to be here to stay, despite the court's assertion that it has not modified the rule.

Interestingly, if such clauses are litigated, this rule can negate some reasons for having a liquidated damages clause in the first place. If such clauses must be litigated, the goals of avoiding litigation and avoiding having to prove actual damages will be frustrated. In the event the clause is ruled an unenforceable penalty, actual damages must be shown in order for the party to recover those damages.

If a party relies on the liquidated damages clause alone and makes no showing of actual damages, that party may not recover if the court refuses to enforce the clause. Likewise, a party attempting to avoid enforcement of the clause must now prepare and present evidence of actual damages and/or the effects of the operation of the clause.

## Drafting Considerations

The enforcement decisions of the courts leave some uncertainty when drafting liquidated damages clauses.

Nevertheless, steps can be taken to include an enforceable liquidated damages clause.

First, there should be a recital that the parties agree that actual damages would be difficult or impossible to calculate. Additionally, there should be an agreement to an amount or a formula by which an amount may be calculated, and a recital that the parties agree that the amount or formula reasonably estimates actual damages in the event of a breach. The parties should avoid listing a single, specific liquidated damages amount that applies regardless of the nature of the breach. While none of these is a magic bullet, they can assist a court in upholding the clause.

Nothing in *TG* should be considered legal advice. For advice or representation on specific legal matters, readers should retain an attorney. ➡

---

*Adams (r\_adams@tamu.edu) is a member of the State Bar of Texas and a research attorney for the Texas Real Estate Research Center at Texas A&M University.*