



# LEGAL BRIEFS

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## Liquidated Damages

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While few of us stop to think about it, the concept of a contract is pretty remarkable. The power of the state is available to private parties to make arrangements among themselves. Not only will the state enforce privately negotiated terms, but the parties are also allowed to vary terms and results between themselves that the state otherwise imposes. It is fairly common, for example, for a contract to require a fixed period for inspection and rejection of goods or to establish a shorter period in which suit has to be brought than the one specified in the state's statute of limitations.

One of the differences between the Law of Torts (the portion of the law dealing with the standard of care and negligence) and the law of contract is the measure of damages that can be awarded. In the law of torts, the damage award is equal to the monetary value of the damage done (even though that may be difficult to figure out). In the law of contracts, the damage awarded is the difference between what was promised and what was actually delivered. To demonstrate this difference there is a case that I remember reading on my very first day in contracts class. A physician had promised a patient with a burned palm that after the physician grafted skin onto the patient's palm, the patient would have a "good

hand." The physician transplanted skin from the patient's chest onto the patient's palm and when the graft healed, the patient had a hairy palm. The patients sued for breach of contract. If the patient had sued in tort, the patient would have had to prove it was negligence to transplant skin from a hairy area of the body to the palm. In addition, the measure of damages would have been the damage of having a hairy palm. However, because the patient sued in contract, negligence did not have to be proven. The question was – did the patient get a "good hand" or not? If not, it did not matter if the physician were negligent. The measure of damages was the difference between a hand with a hairy palm and a "good hand." (This case is *Hawkins v McGee*, 84 NH 114, 146 A. 641 (NH, 1929), and it enjoyed some brief moments of fame when it was mentioned in the 1973 movie *The Paper Chase*.)

Even though the measure of damages in a contracts case is easier to define, it may still be difficult to determine. There could be a statute of limitations on suits under the contract, while the damage caused could be incurred over a substantially longer period of time, perhaps when a suit on the contract could no longer be brought. There could be situations where the damage caused could be affected by other expected developments so that it would be difficult to ascertain the damage related to the breach of contract as compared to damages resulting from

other causes. Because the law of contracts is so flexible, it is possible for the parties to agree on a method to compute damages even when the actual damage can be expected to be difficult to determine. Clauses that fix damages to be paid on a breach of contract are referred to as "liquidated damages provisions." However, the availability of this tool, the ability to agree on a sum to be paid in the event of a breach, can be subject to abuse. If parties have unequal bargaining power, a liquidated damage provision can unfairly punish the weaker party. While courts generally enforce contracts so as to give effect to the intent of the parties, courts are reluctant to enforce penalty provisions because of the potential abuse and because it puts the courts in a position of becoming tools for the strong to persecute the weak.

How does one distinguish between a liquidated damage clause and a penalty? First you have to decide if damages are difficult to ascertain or will damage be fairly clear. Is the purpose of the liquidated damage provision simply to create a penalty for a breach? Second, at the time of entering into the contract, is the liquidated damage provision proportionate to the damage that can be expected to be incurred? In interpreting liquidated damage provisions, courts look at the actual operation of the provision. Language stating that the liquidated damage provision "is not a penalty," for example, is not bind-

ing on the court and may be ignored. If a debt is to be paid in installments, making the whole debt due on nonpayment of an installment is not a penalty. Finally, if a liquidated damage provision acts as liquidated damages in one circumstance but is a penalty in others, it is considered a penalty. (This summary is taken, generally, from section 151 of *Simpson on Contracts*, West Publishing Company, 1954).

### **Sweetwater Hospital Association v Carpenter**

In December 2005, this column discussed a Tennessee case, *Sweetwater Hospital Association v Carpenter*, 2005 WL 249695 (Tennessee Court of Appeals) involving a newly graduated nurse anesthetist. Her hospital had offered to advance the cost of her nurse anesthesia education. In return, however, she was obligated to accept a position at the hospital on graduation. One thing that has always intrigued me about contract cases is the realization that, try as we might, we humans simply cannot foresee everything the future will bring. Although the arrangement seemed fair enough, when the nurse graduated from nurse anesthesia school, the hospital did not have an opening for a nurse anesthetist. It offered her a position, but it was not a position as a nurse anesthetist. Consequently, she accepted a job as a nurse anesthetist at another hospital. Her hospital (the one that paid for her nurse anesthesia education) sued to recover the monies it had advanced for her education. When this column discussed the case, we tried to point out that courts try to give meaning to the parties' intent as expressed in their written contracts. However, when the parties in this case referred to a "position" what was the likelihood that they were contemplating a position other than as a nurse anesthetist? Thus, the plain language that they agreed to turned out to be inadequate to express their intent and despite the statement of the court

that its purpose was to enforce the parties' intent, the court did not make much effort to find out what that intent was.

I'm not sure what was going on in Middle Tennessee around the year 2000, whether it was economic need, a surplus of funds, or something in the water, but it turned out that Sweetwater Hospital was not the only employer in Middle Tennessee willing to finance nurse anesthesia education. The Tennessee Court of Appeals recently issued 2 decisions (*Anesthesia Medical Group, P.C. v Buras*, 2006 WL 2737829 (Tenn. Ct. App.) and *Anesthesia Medical Group, P.C. v Chandler*, 2007 WL 412323 (Tenn. Ct. App.)) in which an anesthesia group paid the educational expenses of nurses to go to anesthesia school. Although the cases dealt with the same contract and the same issue, the court came to different conclusions and the results offer insight into the court's thinking about liquidated damages.

In the *Sweetwater Hospital* case, it had appeared that the contract was not very well thought out. The contract referred to the female nurse as a "him" and appeared to be more appropriate for a part-time educational program rather than funding for a full-time school program leading to the ability to change careers. Anesthesia Medical Group, the group providing funding in the more recent cases, on the other hand, had done a much better job of drafting a contract to meet the specific needs and circumstances of paying for full-time anesthesia school. According to testimony cited in the Court of Appeals' decisions, Anesthesia Medical Group had found it very difficult to find and retain enough CRNAs to fully staff its anesthesia practice. Anesthesia Medical Group then came up with an idea. It would seek out qualified critical care nurses and sponsor them to attend nurse anesthesia school! It would agree to advance up to \$22,500 for tuition assistance,

and the nurse would agree that upon completion of nurse anesthesia school and the nurse becoming a CRNA, the nurse would begin full-time employment with Anesthesia Medical Group at the then prevailing salary rate for CRNAs. If Anesthesia Medical Group did not have a position, the loan would be forgiven. Otherwise, the nurse would agree to work for Anesthesia Medical Group for 3 years. If the nurse did so, loan repayment would also be forgiven. If, however, the nurse failed to complete the program or failed to take or pass the certification examination or failed to comply with any other provision of the agreement, the nurse would be required to repay the loan with interest, to pay any costs incurred by Anesthesia Medical Group for collection, and to pay liquidated damages of \$15,000 (which was reduced to \$10,000 if the nurse completed 12 months of employment and \$5,000 if the nurse completed 24 months of employment. Once the nurse completed 3 years of employment, there was no further obligation for liquidated damages).

### **Anesthesia Medical Group, P.C. v Buras**

In *Buras*, the first of these Tennessee cases, Buras graduated from anesthesia school, took the certifying examination, passed, and went to work for Anesthesia Medical Group at the then prevailing salary. Shortly thereafter, Buras decided that working for Anesthesia Medical Group was "not a good fit." He felt that the attending anesthesiologists did not allow him to exercise enough independent clinical judgment. Once more, as in the *Sweetwater* case, the written terms of the contract were inadequate to address what Buras experienced as real anesthesia practice. When he was a critical care nurse, could Buras have anticipated that when he graduated from anesthesia school he would care about

the style of practice or how closely the anesthesiologist would be supervising him? Could Buras have anticipated that he would come out of anesthesia school wanting to make his own anesthesia decisions and not have them dictated by an attending anesthesiologist? Buras agreed that he breached the contract and was willing to repay the loan plus interest, but he felt that the liquidated damage provision was a penalty designed to force him to accept a practice setting he did not want, and was therefore unenforceable.

Was the \$15,000 a reasonable estimate of costs Anesthesia Medical Group would have to incur to replace him or was it punishment for his resignation to obtain more autonomy? The trial court ruled it unenforceable as a penalty and Anesthesia Medical Group appealed. At trial, the human services coordinator and the chief financial officer of Anesthesia Medical Group testified as to the difficulties of recruiting and retaining CRNAs. First, when Buras resigned, a locum tenens had to be hired while a new CRNA was located. A locum tenens obviously costs more than an employee. In addition, there could be finder's fees, advertising, and other expenses in trying to hire another CRNA. The chief financial officer for Anesthesia Medical Group testified that for the period starting with Buras resignation and ending with the hiring of Buras' replacement, Anesthesia Medical Group had spent \$62,000 for a locum tenens as opposed to the \$30,000 they would have paid in the same period to a permanent CRNA. This meant that the anesthesia group had incurred more than \$32,000 in expenses replacing Buras. Based primarily on the additional expense of \$32,000, the appellate court felt that the \$15,000 liquidated damage provision was a reasonable effort to identify the additional costs the anesthesia group would incur if a nurse anes-

thetist rejected employment, and, therefore the liquidated damage provision was a reasonable estimate of costs and enforceable.

What is troubling about the *Buras* case is that the court looks at the facts and circumstances only from the standpoint of the anesthesia group. For a loan of \$22,500, the anesthesia group will recover not only their principal of \$22,500, interest, and collection costs of \$17,000 but also a \$15,000 liquidated damage provision. The \$15,000 liquidated damage provision makes this an extremely expensive loan to the nurse anesthetist. Buras might be justified in thinking of himself as an indentured servant in 17th century America. For someone who did not have enough money to go to anesthesia school in the first place, the liquidated damage provision makes the cost of the loan for anesthesia school so expensive that it forces the nurse to work for the employer after graduation. Thus, the practical effect of the liquidated damage provision is to force the CRNA to work for the anesthesia group. Whether or not the anesthesia group actually incurred expenses, the liquidated damage provision probably looks like a penalty provision to Buras and is designed solely to force him to work for the anesthesia group.

### ***Anesthesia Medical Group, P.C. v Chandler***

Anesthesia Medical Group entered into the same agreement with other nurses hoping to become CRNAs. In the second case, Chandler was also unable to predict the future. She decided not to accept employment with Anesthesia Medical Group for a much more mundane reason. During her anesthesia training, she met and married an engineer who worked in Huntsville, Alabama. He tried to find a job in the Nashville area but was unsuccessful. To stay with her husband, Chandler would have to join him in Alabama.

Approximately 7 months before graduation Chandler notified Anesthesia Medical Group that because of her marriage she would not be coming to work in the Nashville area, and she wanted to let Anesthesia Medical Group have as much advance notice as possible to replace her.

Anesthesia Medical Group responded that it wanted its \$22,500 loan repaid, it wanted more than \$4,000 in interest paid, and it wanted an additional \$15,000 as liquidated damages as the contract provided. It filed suit. Both parties asked for summary judgment. Once more, the trial court determined that the liquidated damage provision was a penalty and refused to enforce it.

Even though both parties had asked for summary judgment, this was a strange case at the appellate level. First, the issues involved related to the interpretation of the contract. Normally at the appellate level the decision of the trial court as to facts is given a great deal of respect and is often presumed to be correct. But interpreting a contract is a matter of law, not fact, and the trial court's decision had no presumption of correctness. The appellate court made its own decision as if the trial court had never heard the case.

The appellate court set forth its philosophy of interpreting contracts. The purpose of interpreting a contract is to ascertain the contracting parties' intentions. Where the parties have put these intentions in writing, the intent of the parties is presumed to be that which is expressed in the written contract. Chandler challenged the contract on several grounds, the first of which was that it was not enforceable because it was not mutual. Although the contract punished her by charging her \$15,000 if Anesthesia Medical Group offered her a position that she did not take, Anesthesia Medical Group was not

in fact obligated to offer her employment at all. Consequently, she claimed that the contract was not mutual and therefore unenforceable. The court dismissed her objections. It said that Chandler was trying to separate the employment provisions of the contract from the simple loan agreement. However, the court argued, Anesthesia Medical Group was not in the business of lending money. Anesthesia Medical Group only made the loan as a method to recruit CRNAs. The contract had a provision that if Anesthesia Medical Group failed to offer employment to the CRNA, the CRNA would not only be free of the liquidated damage provision but also would not be obligated to repay the amount loaned by Anesthesia Medical Group. The court found this to be sufficient consideration on the part of Anesthesia Medical Group to counterbalance the claim that they were not actually obligated to offer employment.

This brought the court back to the issue it had to face in the *Buras* case. Was the liquidated damage provision an effort on the part of the parties to estimate the damage that would be incurred in the event of a breach where the actual amount of damages would be difficult to determine, or was this merely a penalty designed to force Chandler to accept employment she no longer wanted? If this were an attempt to estimate damages it was enforceable but if it was a penalty, it was not enforceable.

The major difference between the *Chandler* case and the *Buras* case was that Chandler had given Anesthesia Medical Group more than 7 months' notice that she would not be joining their practice. If Anesthesia Medical Group was able to replace her in less than 7 months, it could avoid the expense of hiring a locum tenens, the primary component of its anticipated

damages. The trial court had not considered this possibility and the appellate court sent the case back for further findings of fact. If Anesthesia Medical Group could show that at the time the contract was entered into, it reasonably expected significant damages, the \$15,000 liquidated damage provision would be enforced. Unlike the interpretation of the contract, this was a factual not a legal issue and, since factual issues were involved, summary judgment was inappropriate and the case was sent back to the trial court for further proceedings.

### **Court's Thinking and Approach**

Having 2 cases based on the same contract decided by the same court exposes the court's thinking and the court's approach. In both cases the question was whether the liquidated damage provision was a penalty or was merely an effort to estimate damages when the determination of actual damages might be difficult. In the *Buras* case the CRNA had gone to work for the anesthesia group and then resigned. Arguably, this was the very thing the anesthesia group was concerned about. They had to hire a locum tenens while searching for a replacement CRNA. In the *Chandler* case, the CRNA had given them a great deal of advanced warning. It was not clear that the anesthesia group would have to hire a locum tenens when they had so much warning and there would be significantly less disruption. In those circumstances was the liquidated damage provision a reasonable way to estimate damage or was it a penalty?

While the court's actions seem to reflect the distinction made in the facts of the case, the court's reasoning is troubling, nonetheless. As the court made clear in both cases, liquidated damages are only permitted if, at the time the contract was

entered into, it can be anticipated that proof of actual damage will be difficult thereby justifying the parties in trying to reach agreement on what the damages will be in the event of a breach. If the court believed that this was a reasonable process in the *Buras* case, then why would it not have been just as reasonable in the *Chandler* case? It is true in *Chandler* that the anesthesia group was given sufficient notice that they might avoid the need to hire a locum tenens, but there was no way the parties could have known at the time they entered into the contract that they would get so much advance notice. Moreover, trying to figure out how much damage the anesthesia group will incur even with advance notice is no less difficult in the *Chandler* case than it would be in the *Buras* case. In the *Buras* case, it turned out that it was quite possible to figure out, fairly precisely, what actual damages were. In the *Chandler* case, trying to figure out what the damages were with so much notice will be more confusing. Yet the court held that the *Buras* case was an appropriate application of liquidated damages and was uncertain as to the *Chandler* case.

And, what about the aspect of liquidated damages that if the clause operates as a penalty in any circumstance, it is a penalty and unenforceable in all circumstances? Isn't the court sending this case back to the trial court precisely because it recognizes that there could be a circumstance where there would be no damage? Does not that make it clear that this clause was intended as a penalty and should not have been enforced in either case?

Nonetheless, the cases are interesting because they show a court trying to give effect to the parties' intent even though there are limits to how far the court can go in letting the parties set their own terms.