United States: Courts Run Hot And Cold On Liquidated Damages
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Liquidated damages are often too good to be true. A staple of franchise agreements (which are largely trademark licensing contracts) and Lanham Act claim settlements, they promise predictability all the way down the decision tree. If drafted improperly, however, they can either grossly underestimate actual damages or be so overgenerous to a markholder that courts won't enforce them. On the other hand, because of the abstract nature of trademark rights, courts often use reasonable liquidated damages clauses as the starting point for determining monetary awards. Liquidated damages clauses are one of the few areas in which courts will not hesitate to pass on the fairness of the terms of a contract, a traditional common law no-no. The danger is that a court will not jut refuse to enforce a liquidated damages clause as written, but that rather than "save" or reform it, will throw out the whole clause, notwithstanding what other terms or consideration was surrendered to secure it.

There are plenty of cases rejecting the use of a liquidated damages clause as a measure of trademark or trademark-related damages. In Rodeway Inns Int'l, Inc. v. Amar Enterprises, Inc., 742 F. Supp. 365 (D. Miss. 1990), the District Court rejected the notion that a liquidated damages clause in a franchise contract constituted evidence of actual damages appropriate to grant summary judgment as to damages in a Lanham Act case. "A determination of damages under the Lanham Act must be supported by evidence of actual damage suffered by the plaintiff," the court said. Other courts have more recently rejected liquidated damages in Lanham Act / franchise cases on "reasonableness" grounds, i.e., that they are not a reasonable estimate of actual damages. See, Days Inns of Am., Inc. v. Regency Manor Ltd., 94 F. Supp. 2d 1200 (D. Kan. 2000).

Some courts, however, have refused to rule that liquidated damages clauses are disguised penalties. Finding that no better evidence of infringement of a franchise agreement is available, they have enforced them as written. See, e.g., Hawkins Pro-Cuts v. DJT Hair, 1997 U.S. Dist. LEXIS 22418 (D. Tex. 1997). Much depends on the facts of the case and the precise terms of the clause. It is also fair to say that courts are generally more open to liquidated damages clauses in non-franchise settings than in franchise agreements, where there is a strong presumption of "unequal bargaining strength" between franchisor and franchisee.

For example, in Jordache Enterprise, Inc. v. Global Union Bank, 688 F. Supp. 939 (S.D.N.Y. 1988), the owner of the trademark for a brand of designer jeans seized a shipment of counterfeit merchandise. The parties entered into a settlement agreement premised on the removal of the labels and sale of the jeans only in Hungary, with $100,000 in "indemnification" by the infringer of the mark owner if the jeans were instead sold in the U.S. The jeans, however, ended up in the basement of a Brooklyn pizzeria and 35 percent of them eventually made their way into the U.S. market. The court awarded 35 percent of the "indemnity" amount, which it described as appropriate liquidated damages in a situation where actual damages were difficult to ascertain.

Jordache provides a valuable lesson in liquidated damages clause drafting. The parties had not specified whether the liquidated damages were payable upon the sale of the entire quantity of counterfeit jeans in the U.S., the sale of only a single pair, or something in between. The court rejected the notion that the damages were payable regardless of the quantity of jeans shipped in violation of the settlement, noting that to hold thusly would be to enforce a penalty. On the other hand, the court refused to rule that the entire $100,000 was payable under circumstances where a third of the jeans were wrongfully sold in the U.S. The court assumed a "reasonable" interpretation: That the $100,000 was meant to apply to the entire shipment. The court then had no difficulty prorating the award.

While it may be the case that this was the most "reasonable" interpretation of the provision, it is doubtful that this was the intention of the parties. Most trademark owners would weigh the payment of liquidated damages very heavily toward the initial infringements. In other words, they would front-load it. In fact, in some circumstances, a little bit of trademark infringement may be disproportionately more damaging to an enforcement program than a simple proration a la Jordache would remedy. Thus it may be advisable, in a Jordache-like situation, to specify some "reasonable" sliding scale to head off a straightforward linear arrangement that might be inferred by the court. Your rationale – which should be recited appropriately in the contract – can be along the lines that properly disincentivizing the infringing party at the front end will lessen the total infringement. While this thinking may or may not be appropriate for your client's goals, it would be hard to dismiss such an approach as obviously "unreasonable" and, hence, an unenforceable penalty clause.

Similarly, in Levitt Corp. v. Levitt, 1978 U.S. Dist. LEXIS 15820 (E.D.N.Y. 1978), the defendant in a trademark infringement case breached a settlement agreement containing a liquidated damages clause. The trademark in question was the famous "Levittown" mark as well as marks confusingly similar to it, used in connection with the "construction, promotion, development, advertisement, and sale of residential dwellings." The breached settlement agreement contained a per diem amount of $520.54 for each day of use. Noting the difficulty of calculating trademark damage, the court enforced the clause – but roundly rejected the plaintiff's contention that this was a floor for damages. That, wrote the court, would be the essence of a penalty, and not enforceable, whereas true liquidated damages take into account the difficulty of assessing actual damages with precision, while making some attempt at setting a predictable estimate of those damages.

A few rules, then, about drafting liquidated damages clauses in trademark related settlements and agreements:

1. Make quantities, units, and their financial implications clear – and rational, i.e., they should make sense as a matter of reality and logic.

2. The rationality of the numbers involved should be supported, or supportable, by the record.

3. Try to create a record that supports an argument of "buy in" by the adversary of the rationale and the numbers. Do not, however, expect boilerplate recitals of what you would like to demonstrate, built into the settlement agreement, to do the trick – they are just part of the clause that the court is passing on as a whole.

4. Above all, the terms of a trademark-related liquidated damages clause should not only be rational – make sense – but they should be modest and fair. Essentially, markholder counsel must think of the transaction as one in which it is making a bargain, no matter how strong its settlement position: In exchange for an agreement to a reasonable, enforceable, liquidated damages clause – for an amount lower than it may otherwise conceivably achieve in an ideal world of transparent proof and receptive judges – it receives a degree of certainty and predictability. You will not do better than that.

Any settlement agreement is stronger if it, and the associated consent order that effectuates it, explicitly recite that the court retains jurisdiction to enforce its terms. Otherwise, some courts view the settlement as merely a contract that may be breached. It is usually better to revive an old docket number and have an offended judge to whom to present the breach of the settlement agreement than to have to sue anew, especially if the new action is brought after a rebuff by the original court. Is there ever a circumstance where you are so unhappy with the direction of your original judge that you would rather take a chance at a new one and leave out this provision? That’s a question to think about, but not one we would even try to answer in HTML.