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Indiana Supreme Court Clarifies When Liquidated Damages Become 'Unenforceable Penalties'

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On December 18, 2019, in *American Consulting, Inc. d/b/a American Structurepoint, Inc. v. Hannum Wagle & Cline Engineering, Inc., et al.,* the Indiana Supreme Court provided clarity about when liquidated damages become unenforceable penalties. The decision related to restrictive covenants, but the ruling has implications for liquidated damages in all types of contracts. The court also left unresolved the question of which of two standards should apply for evaluating the element of "an absence of justification" in tortious interference claims.

The main issue before the court was whether the liquidated damages provisions in several restrictive covenants constituted unenforceable penalties, i.e., sums grossly disproportionate to the loss. The court decided that the provisions were unenforceable penalties for the following reasons:

- The employees' salaries (which factored into the measure of liquidated damages) did not reasonably correlate to and were not reflective of revenue lost by the party trying to enforce the provisions.
- The liquidated damages sums were not certain but rather based on "a percentage of a yet to be ascertained [amount]."
- The amounts of the damages far exceeded the defendants' salaries, making the damages appear punitive.

Background

In 2015, American Consulting, Inc., d/b/a American Structurepoint, Inc. (ASI) sued Hannum Wagle & Cline Engineering, Inc., d/b/a HWC Engineering, Inc. (HWC), a competitor in the construction industry, along with several of its employees who had previously worked for ASI. The claims against the former employees—Marlin A. Knowles Jr., Jonathan A. Day, David Lancet—were for breach of restrictive covenants, and the claims against HWC included claims for tortious interference with contractual relationships.

After ASI won a preliminary injunction in the trial court, the Court of Appeals of Indiana affirmed the decision in all respects on the issues of irreparable harm, reasonable restrictions, laches, and the enforceability of extension clauses, among other issues. The trial court determined that the liquidated damages provision was a penalty and therefore unenforceable; the appellate court initially did not address the issue. After remand and another appeal, the Indiana Court of Appeals on May 23, 2018, reversed the trial court, finding the liquidated damages clauses in ASI's contracts were enforceable. HWC and the employees sought transfer, which the Indiana Supreme Court granted, vacating the court of appeals' decision and issuing a decision on December 18, 2019.

Liquidated Damages

"'Liquidated damages' refers to a specific sum" designated by the parties to a contract as "'the amount of damages to be recovered,'" whether it exceeds or is less than actual damages, that is typically awarded without proof of damages. When liquidated damages become unenforceable penalties is a question of law. Difficulty in ascertaining damages is not a sufficient reason to enforce a liquidated damages clause.

The court highlighted the uncontested facts about the liquidated damages provisions that it found to be "facially problematic":

- Knowles was required to pay 50 percent of the salary of any employee that Knowles caused to leave his former employer (ASI).
- Day and Lancet were required to pay 100 percent of the salary of any employee that they caused to leave their former employer (ASI).
- Knowles was also required to pay 45 percent of ASI's prior 12 months of revenue generated by any client Knowles successfully solicited to do business with Knowles's new employer (HWC).

The court found fault with these provisions for numerous reasons.

First, the employees' salaries from the prior year did not reasonably correlate to and were not reflective of revenue for ASI—which is what a court would typically examine to determine damages. While an employee's salary factors into revenue, there are other variables. The court was also troubled by the clauses requiring Knowles, Day, and Lancet to pay different salary amounts among the contracts: lower-paid employees (Day and Lancet) had to pay a higher percentage of their salaries than the higher-paid Knowles. The court noted the practical effect of this language when several employees were recruited: ASI was seeking 250 percent of the employees' salaries, an amount the court found highly unlikely to be representative of damages, which was the cost of replacing them.

Second, prior Indiana law had allowed liquidated damages resulting in a sum certain and "reasonably tied to the actual losses." The amounts here were not. Instead, they were variable: (a) they were based on a percentage of a yet-to-be-determined amount; (b) the percentages in the provisions were "not tied to ASI's actual lost revenue from losing its employees"; and (c) the amounts of the liquidated damages "far exceed[ed] the salaries of the Defendants," making the amounts appear punitive.

Third, the court found the provisions "applied the same punishment for a broad range of conduct" and were punitive, appearing to be "meant to secure performance and punish the breaching party, not to compensate ASI's actual losses." For example, liquidated damages applied to Knowles whether he successfully solicited or recruited ASI employees, or merely attempted to do so. The other two employees were hourly wage earners, but the amount of their liquidated damages would have exceeded their own salaries if they were found to have been in breach of their restrictive covenants.

Based on this reasoning, the court found that the defendants had made an initial showing that liquidated damages were facially unreasonable, rendering the trial court's prior grant of summary judgment in favor of ASI improper and placing the burden on ASI, as the plaintiff, to show that the liquidated damages correlated with actual damages.

The Indiana Supreme Court was not persuaded that the liquidated damages provisions were not reasonable forecasts of ASI's damages. It found that "the person who recruited an employee [was] not tied to the recruited employee's value or ASI's loss. It faulted ASI for a lack of evidence of employee recruitment spending or a correlation between liquidated damages and actual damages. It found the liquidated damages provision related to customer solicitation would result in "a windfall to ASI," making the damages punitive in nature.

The result of the ruling was that ASI could seek only actual damages for its breach-of-contract claims.

Tortious Interference With Contractual Relations

For the tortious interference with contractual relations claim against HWC, the Indiana Supreme Court noted the parties' dispute about the two standards that Indiana courts have used to determine the element of an absence of justification: (1) an intentional act, without a legitimate business purpose, and a malicious breach "exclusively directed to the injury and damage of another"; or (2) whether the conduct was "fair and reasonable" under five elements for proving tortious interference set forth in the *Restatement.*

The court elected not to decide between the standards, finding that an issue of material fact remained regardless of which of the two approaches for determining an absence of justification was adopted. Thus, the court found, the grant of summary judgment had been improper and the case required remand to the trial court.

Conclusion

Practitioners may want to think through liquidated damages clauses when drafting or reviewing contacts in light of this decision, which highlights the difficulty of having enforceable provisions that are still worthwhile.

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