On April 1, a mechanic contracted to repair a toy company's molding machine and to complete the job by April 6. On April 2, the toy company contracted to manufacture and deliver specified toys to a customer on April 15. The toy company knew that it would have to use the machine then under repair to perform this contract. Because the customer's order was for a weeklong toy conference, the customer and the toy company included in their contract a liquidated damages clause, providing that the toy company would pay $5,000 for each day's delay in delivery after April 15.

The mechanic was inexcusably five days late in repairing the machine, and, as a result, the toy company was five days late in delivering the toys to the customer. The toy company paid $25,000 to the customer as liquidated damages and now sues the mechanic for $25,000. Both the mechanic and the toy company knew when making their contract on April 1 that, under ordinary circumstances, the toy company would sustain little or no damages of any kind as a result of a five-day delay in the machine repair.

Assuming that the $5,000 liquidated damages clause in the customer's contract is valid, which of the following arguments will serve as the mechanic's best defense to the toy company's action?

A. By entering into the contract with the customer while knowing that its molding machine was being repaired, the toy company assumed the risk of any delay loss to the customer.

B. In all probability, the liquidated damages paid by the toy company to the customer are not the same amount as the actual damages sustained by the customer in consequence of the late delivery of the toys.

C. The mechanic had no reason to foresee on April 1 that the toy company would suffer consequential damages in the amount of $25,000.

D. Time was not of the essence in the contract between the mechanic and the toy company.

Explanation:

Consequential damages

Damages for losses stemming from nonbreaching party's special circumstances if breaching party:

knew of those special circumstances
OR

could have reasonably foreseen harm caused by breach

After establishing a **breach-of-contract** claim, the nonbreaching party is entitled to recover compensatory damages to compensate for actual economic losses. **Compensatory damages** include:

expectation damages – the lost value of the breaching party's performance *and*

consequential damages – losses that arise from the nonbreaching party's **special circumstances** (eg, an unrelated contract) that were **reasonably foreseeable** to the breaching party when his/her contract was formed.

Here, the mechanic was inexcusably five days late in repairing the toy company's molding machine. As a result, the company lost $25,000 under its unrelated contract with the customer (special circumstance) formed on April 2. But when the mechanic contracted with the company on April 1, he knew that the company ordinarily would sustain little or no damages from a five-day delay. Therefore, the mechanic's best defense to the company's action is that on April 1 he had no reason to foresee the company's consequential damages.

(Choice A) Consequential damages are unavailable if the nonbreaching party assumed the risk of that loss when the contract was formed. This is true even when the loss was foreseeable to the breaching party. But here, the toy company's allocation of risk with the *customer* has no bearing on its allocation of risk with the *mechanic*.

(Choice B) A liquidated damages clause is invalid if the liquidated amount was unreasonable in relation to the damages that *might* be sustained. But since liquidated damages are designed to protect the parties when the actual damages are uncertain, liquidated damages can differ from the *actual* damages sustained.

(Choice D) To determine whether a party's late performance is a material breach, courts consider all the circumstances, including whether the contract stated that time was of the essence. But even if this language is missing (as seen here), a party's late performance can still be a material breach.

Educational objective:

Compensatory damages for breach include (1) expectation damages for the lost value of the breaching party's performance and (2) consequential damages for losses that arise from the nonbreaching party's special circumstances that were reasonably foreseeable to the breaching party when the contract was formed.

References

Restatement (Second) of Contracts § 351 (Am. Law Inst. 1981) (explaining that consequential damages must be foreseeable).