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## RECENT DEVELOPMENT

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### ***BARRIE SCHOOL V. PATCH: THERE IS NO DUTY FOR A NON-BREACHING PARTY TO MITIGATE DAMAGES WHEN THE CONTRACT CONTAINS A VALID LIQUIDATED DAMAGES CLAUSE.***

**By: George Perry**

The Court of Appeals of Maryland held that there is no duty to mitigate damages when a contract contains a valid liquidated damages clause. *Barrie School v. Patch*, 401 Md. 497, 933 A.2d 382 (2007). More specifically, since there is no duty to mitigate, the breaching party is liable for liquidated damages even if the non-breaching party suffered no actual harm. *Id.* at 515, 933 A.2d at 393.

Andrew and Pamela Patch ("the Patches") enrolled their daughter in the Barrie School ("the School"), a non-profit Montessori school, for the 2004-2005 academic year. In doing so, the Patches entered into a re-enrollment agreement with the School. With this agreement, the Patches were required to pay a non-refundable deposit and the total tuition amount in two installments. It also included an escape clause allowing unilateral cancellation by written certified letter before May 31, 2004. The escape clause required that parents pay the full tuition if they failed to withdraw their child before the deadline.

The Patches withdrew their daughter from the School forty-four days after the withdrawal deadline and demanded a refund of their initial deposit. Furthermore, they refused to pay the remaining balance. It was undisputed that the School met its enrollment numbers and suffered no actual harm.

The School filed a breach of contract action in the District Court of Maryland for Montgomery County against the Patches for the remaining tuition balance, twelve percent interest, and attorney's fees. The Patches argued that the School had a duty to mitigate damages.

The district court found that the contract was valid and the liquidated damages clause was reasonable. However, it ruled that the School had a duty to mitigate damages. The School appealed to the Circuit Court for Montgomery County on the issue of whether there was a duty to mitigate damages, and the Patches cross-appealed on the

issue of whether the liquidated damages clause amounted to a penalty. The circuit court affirmed the district court, although it did note that the School, in effect, mitigated damages by enrolling more students than its budget projections called for. The Court of Appeals of Maryland granted both the School's petition for a writ of certiorari and the Patches' cross-petition.

Maryland courts define liquidated damages as a specific sum agreed upon by the parties at contract formation to be paid as damages in the event of a breach. *Barrie School*, 401 Md. at 507, 933 A.2d at 388 (citing *Bd. of Educ. v. Heister*, 392 Md. 140, 155, 896 A.2d 342, 351 (2006)). A liquidated damage clause must satisfy the following three elements: 1) the clause must provide clear and unambiguous terms for a specified sum; 2) the liquidated damages must reasonably compensate anticipated damages from a breach; and 3) they must be binding agreements before the fact, barred from being changed to comply with damages after the fact. *Id.* at 509, 933 A.2d at 389 (quoting *Heister*, 392 Md. at 156, 896 A.2d at 352). A court may deem liquidated damages a penalty if the amount grossly exceeds damages that could reasonably have been expected to stem from a potential breach. *Id.* at 509, 933 A.2d at 389-90 (quoting *Balt. Bridge Co. v. United Rys. & Elec. Co.*, 125 Md. 208, 215, 93 A. 420, 422 (1915)). Maryland courts will uphold a liquidated damages clause as valid if the clause fairly estimates potential damages at the time the parties entered into the contract and if, at that time, the damages were either impossible or very difficult to estimate. *Id.* at 510, 933 A.2d at 390.

While the Court agreed that the liquidated damages clause was valid and not a penalty, it held that the School had no duty to mitigate. *Id.* at 515, 933 A.2d at 393. Specifically, the Court found mitigation to be part of a court's determination of actual damages resulting from a breach of contract, and a valid liquidated damages clause obviated the need to mitigate absent some statutory mandate. *Id.* at 513-15, 933 A.2d at 392-93. However, the Court's holding sparked Chief Judge Bell's dissent, who viewed this conclusion as undermining "basic principles of contract law pertaining to the equity and reasonableness of contract remedies." *Id.* at 519, 933 A.2d at 395 (Bell, C.J., dissenting).

The majority noted that parties establish the amount for a liquidated damages clause at the contract's formation. *Id.* at 509, 933 A.2d at 389 (majority opinion). Courts must use this reference point in weighing the clause's reasonableness given the unpredictability of actual

damages at the time of contract formation and before breach. *Id.* at 510, 933 A.2d at 390. If, at the time of contract formation, the liquidated damages clause grossly exceeds expected damages resulting from a potential breach of contract, the clause is a penalty. *Id.* at 509, 933 A.2d 390.

However, the dissent opined that one does not realize the validity of a liquidated damages clause until there is a breach of contract. *Id.* at 522, 933 A.2d at 397 (Bell, C.J., dissenting). The dissent termed this the "retrospective view" of liquidated damages. *Id.* at 522, 933 A.2d at 397 (Bell, C.J., dissenting). Therefore, the dissent posited that, in reviewing whether a liquidated damages clause is a penalty, one should assess whether actual damages resulted from the breach. *Id.* at 522, 933 A.2d at 397 (Bell, C.J., dissenting). In assessing the viability of a liquidated damages clause, one must look at all existing circumstances at the time of contract formation and breach. *Id.* at 524, 933 A.2d at 398 (Bell, C.J., dissenting). The dissent found that even though the Patches breached the contract, since the School still met its enrollment projections, the amount of liquidated damages was grossly disproportionate to the actual harm. *Id.* at 524-25, 933 A.2d at 398-99 (Bell, C.J., dissenting).

In holding that the School had no duty to mitigate, the Court stated that mitigation is part of a court's determination of actual damages while liquidated damages clauses are a contracted remedy in case of breach. *Id.* at 513, 933 A.2d at 392 (majority opinion). By considering two distinct types of damages, this rationale obviates subsequent facts, like actual harm, because the liquidated damages clause only considers the facts at contract formation. *Id.* at 515, 933 A.2d at 393. The majority found this approach preserved the benefits of a liquidated damages clause and was consistent with using the moment of contract formation to judge the reasonableness of the clause. *Id.* at 515, 933 A.2d at 393.

The dissent believed that the Court should have followed the general rule that one may not recover damages if the consequences of the breach are avoidable. *Id.* at 531, 933 A.2d at 402 (Bell, C.J., dissenting). Given the fact that the School suffered no actual harm, this relief would doubly compensate the school, equating to a windfall. *Id.* at 529, 933 A.2d at 401 (Bell, C.J., dissenting). Considering the situation retrospectively, the School's recovery would be excessive, rendering the liquidated damages clause unenforceable. *Id.* at 531, 933 A.2d at 402 (Bell, C.J., dissenting). The dissent found this approach to be a reasonable one because, given the appropriate

circumstances, it merely requires the non-breaching party, like in any breach of contract action, to prove actual damages and an effort to mitigate. *Id.* at 531, 933 A.2d at 402 (Bell, C.J., dissenting).

By holding that there is no duty for the non-breaching party to mitigate damages, the Court of Appeals of Maryland affirmed the power of a valid liquidated damages clause. The dissent criticizes this holding as being divergent from basic principles of equity and reasonableness of contract remedies. However, by considering the liquidated damages clause as being separate from the requirement to mitigate damages, the Court creates a sense of finality when a party breaches a contract containing a valid liquidated damages clause. Maryland attorneys must carefully assess liquidated damages clauses when evaluating contracts because subsequent facts, like whether the non-breaching party suffers actual harm, are irrelevant.