

# CONTRACT DAMAGES AS SUBSTITUTE FOR FULL PERFORMANCE

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One of the first lessons contract students learn is that a party to a contract has a choice between two courses of action. The party can either perform the contract according to its terms or pay damages for not performing. This concept is usually stated in a neutral, nonjudgmental manner, as if it does not matter which course is chosen. Indeed, modern contracts textbooks teach that there is nothing morally wrong with breaching contracts; in some instances it may even be economically efficient to breach.<sup>1</sup> One of the principal justifications for this counterintuitive notion is found in the theory of damages: So long as the breaching party is willing to pay full compensation for the breach, the other party will be "made whole" and the nonperformance will be remedied entirely.<sup>2</sup> In theory, the payment of damages is the monetary equivalent of full performance.

Practicing lawyers and their clients, of course, know differently. The successful prosecution of a breach of contract claim rarely means that the plaintiff has been "made whole." The plaintiff may rejoice at first upon hearing that the case on the merits is strong, only to despair when told about the difficulties of obtaining full compensation and the expenses that must be borne by the plaintiff to prosecute the action. As it turns out, the payment of damages seldom, if ever, even approximates the equivalent of contract performance.

The problem of obtaining full compensation from the breaching party, or as close to full compensation as possible, is a vexing one for lawyers who litigate contract claims. The client may think that he or she has been harmed in a myriad of ways, but some of the injuries may be speculative, intangible, difficult to quantify in dollar amounts, or simply unrecoverable in contract actions. The Indiana Court of Appeals recently reaffirmed, for example, longstanding rules that damages for emotional distress<sup>3</sup> and lost reputation<sup>4</sup> are not compensable under a contract theory, even though the injuries are very real in the eyes of the

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1. *E.g.*, JOHN P. DAWSON ET AL., *CASES AND COMMENT ON CONTRACTS* 31 (6th ed. 1993).

2. *See* RESTATEMENT (SECOND) CONTRACTS, Introductory Note and Reporter's Note, ch. 16 (1981) ("[T]he principal purpose of the rules relating to breach is to place the injured party in as good a position as he would have been in had the contract been performed.").

3. *Holloway v. Bob Evans Farms, Inc.*, 695 N.E.2d 991 (Ind. Ct. App. 1998) (holding that distress damages are not available in contract to plaintiff who found a half-cooked worm on her fork while eating at restaurant).

4. *Wells v. Stone City Bank*, 691 N.E.2d 1246 (Ind. Ct. App. 1998) (holding that bank that wrongfully dishonored checks not liable for lost business reputation or profits resulting from "loss of face" in industry; reputation losses only compensable in actions for libel, slander, abuse of process, malicious prosecution, and third-party contract interference).

plaintiff. Lost profits and other consequences of the breach may be difficult to prove. Moreover, most lawyers want to be paid for their work, and under the American Rule even a successful plaintiff in a breach of contract action will have to bear her own legal expenses.<sup>5</sup> The costs of litigation may exceed or substantially reduce any expected recovery, leaving the client with the disheartening choice of either compromising a valid claim by accepting a partial settlement, or prosecuting to the end and winning a pyrrhic victory.

The prospect of not recovering for these types of losses motivates lawyers to seek additional, sometimes creative, ways of obtaining greater damage recoveries that may more closely approximate the monetary equivalent of performance, and thus make the client's case worth pursuing. This Article discusses some of the things lawyers can do, both in the contract drafting stage and in the course of litigation, to increase the chances of obtaining the monetary equivalent of performance from the breaching party. It begins with a review of the basic measure of damages for breach of contract in Indiana, and discusses some of the problems generated by those rules. The Article then examines five ways of enhancing damage recoveries to overcome some of these problems: expansive approaches to consequential damage recoveries, creative arguments for punitive damage awards, tactics for obtaining attorney's fees, ways to claim prejudgment interest, and aggressive use of liquidated damages provisions.

## I. COMPENSATORY DAMAGES FOR BREACH OF CONTRACT

When a contract is breached, the traditional remedy is an award of money damages. A court will order specific performance of the contract only in the unusual case where an award of damages would be inadequate, causing the aggrieved party irreparable injury if performance is not mandated. When a seller of real property breaches a land sale contract, the buyer might obtain specific performance by arguing that the land is unique and cannot be replaced at any price.<sup>6</sup> Occasionally, the buyer of goods or services can also secure an order of specific performance by showing that the goods or services are unique and cannot be obtained elsewhere.<sup>7</sup> The general presumption applied in the vast majority of contract actions, however, is that the aggrieved party will be limited to a claim for compensatory damages.

The way in which courts usually fix compensation is by awarding expectancy

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5. See *infra* notes 95-96 and accompanying text.

6. Land is generally regarded as unique, so the purchaser can almost routinely secure a decree of specific performance. See *North v. Newlin*, 416 N.E.2d 144 (Ind. Ct. App. 1981).

7. See, e.g., *Brown County Art Guild, Inc. v. Mann*, 430 N.E.2d 1181 (Ind. Ct. App. 1982) (addressing contract for sale of art work). Section 2-716 of the Uniform Commercial Code provides that "specific performance may be declared where goods are unique or in other proper circumstances." U.C.C. § 2-716. See also *Massachusetts Mut. Life Ins. Co. v. Associated Dry Goods Corp.*, 786 F. Supp. 1403 (N.D. Ind. 1992) (ordering anchor store in shopping mall to honor lease because irreparable injury would result if the store closed).

damages.<sup>8</sup> This requires the court to create a hypothetical situation. The court attempts to reconstruct the financial position the aggrieved party would have occupied if the contract had been performed, and compares it to the financial position following a breach. The difference between the two, in dollar amount, is the damage award. The aggrieved party is thus, in theory, placed in the same position it would have occupied had the contract not been breached.<sup>9</sup> This is frequently stated as awarding "lost bargain" damages or giving the aggrieved party the "benefit of the bargain."<sup>10</sup>

The method for computing the lost bargain in dollars will depend on the circumstances of each case, but courts have developed general rules. One typical approach is a market-based computation. The court compares the market value that the goods/land/services would have had if the contract had been performed, with the market value of the goods/land/services after nonperformance, i.e., on the date of the breach. This is designed to give the aggrieved party the same amount of wealth or net worth as was promised in the agreement. The market-based method is often used in land sale cases where the buyer has breached. The seller is given the difference between the contract price and the market value of the land.<sup>11</sup> It may also be useful in construction cases when the builder has breached. The owner is given the difference between the value the property would have had if the construction had been done properly, compared with the value of the property in its condition on the date of nonperformance.<sup>12</sup> Proving market values may require estimates from real estate appraisers or other expert witnesses.<sup>13</sup> The market-based method is also endorsed by the UCC when the buyer or seller breaches a contract for the sale of goods. The damages are the difference between the contract price and market price on the date of breach.<sup>14</sup>

The market measure of damages is useful in some cases, but it can be unsatisfactory in the eyes of the aggrieved party. In a land sale contract, for instance, the market value of the real estate on the date of breach might be the

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8. See *Holloway v. Bob Evans Farms, Inc.*, 695 N.E.2d 991, 995 (Ind. Ct. App. 1998) ("plaintiff is not entitled to be placed in a better position than he would have been had the breach not occurred").

9. See David H. Vernon, *Expectancy Damages for Breach of Contract: A Primer and Critique*, 1976 WASH. U. L.Q. 179.

10. See *Hudson v. McClaskey*, 597 N.E.2d 308, 309 (Ind. 1992).

11. See *Annon II, Inc. v. Rill*, 597 N.E.2d 320, 326 (Ind. Ct. App. 1992); *Arlington State Bank v. Colvin*, 545 N.E.2d 572, 575 (Ind. Ct. App. 1989).

12. See, e.g., *Pierce v. Drees*, 607 N.E.2d 726 (Ind. Ct. App. 1993); *Gough Constr. Co. v. Tri-State Supply Co.*, 493 N.E.2d 1283 (Ind. Ct. App. 1986).

13. There are three accepted methods of determining a property's fair market value: (1) the current cost of reproducing the property less depreciation; (2) the value indicated by recent sales of comparable properties in the market; and (3) the value that the property's net earning power will support based upon the capitalization of net income (the "income approach"). Courts may combine all three approaches to determine market value. See *Annon II*, 597 N.E.2d at 326-27; *Ohio Cas. Ins. Co. v. Ramsey*, 439 N.E.2d 1162, 1167 (Ind. Ct. App. 1982).

14. See U.C.C. § 2-708(1) (seller's damages); § 2-713(1) (buyer's damages).

same as the contract price. The damage computation may then be zero, because the seller's net worth is no worse after the breach. Yet the seller is still in possession of land she had expected to sell, and she must now wait for another buyer.<sup>15</sup> An example from a construction contract is *Willie's Construction Co. v. Baker*.<sup>16</sup> The Bakers contracted to have their new home built with one hundred inch basement ceilings, twelve inches higher than the norm, at an extra cost of only \$414. The builder constructed the basement with the standard height ceilings, and the Bakers sued for breach of contract. Evidence showed that the market value of the house was not reduced at all by the lower ceiling height, so the market measure of damages was zero.<sup>17</sup>

The Bakers successfully argued, however, that the court should use an alternative approach—the cost of conforming the performance to the contract specifications, which came to \$24,000. This illustrates the second general method courts may use in assessing contract damages—the “cost-of-cure” computation,<sup>18</sup> in which the court awards the price of repairing or replacing the property or services.<sup>19</sup> This may be the only way to provide adequate compensation to the plaintiff. In *Willie's Construction*, the court observed that the fair market value of the home did not necessarily reflect the value of the deep basement to the Bakers.<sup>20</sup> It was difficult to put a valuation on that feature because the Bakers requested it as a matter of personal taste, not because it would increase the value of their house.<sup>21</sup> The only way to give them the monetary equivalent of full performance was to award \$24,000 damages so they could have the ceilings raised.

The cost-of-cure computation can be a useful tool for plaintiffs in contract actions because it enables them to purchase the goods or services that were bargained for. But a court will not use this approach if it is concerned that the plaintiff is getting a windfall by taking the money and not doing the repair or replacement. In *Willie's Construction*, for example, there was no guarantee that the Bakers would use the \$24,000 to deepen the basement. They could keep the \$24,000, and their net worth would be increased by that amount. The plaintiffs would be overcompensated and receive more than the benefit of the bargain.

The cost-of-cure remedy is used often in Indiana, and was applied recently

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15. See *Stoneburner v. Fletcher*, 408 N.E.2d 545, 551 (Ind. Ct. App. 1980) (refusing to use market measure because damages would be zero).

16. 596 N.E.2d 958 (Ind. Ct. App. 1992).

17. See *id.* at 960.

18. See *Clark's Pork Farms v. Sand Livestock Sys.*, 563 N.E.2d 1292, 1297 (Ind. Ct. App. 1990). This damage computation method is also endorsed in section 348 of the second Restatement of Contracts. RESTATEMENT (SECOND) OF CONTRACTS § 348 (1981).

19. This “cost of cure” alternative approach is also reflected in the UCC provisions allowing an aggrieved seller to resell the goods and recover the difference between the resale price and the contract price, U.C.C. § 2-706, and an aggrieved buyer to recoup the cost of “cover” when he buys the goods from someone else after the breach, U.C.C. § 2-712.

20. *Willie's Constr.*, 596 N.E.2d at 961.

21. See *id.*

in *Bee Window, Inc. v. Stough Enterprises, Inc.*,<sup>22</sup> another situation in which the damage award exceeded the contract price. Bee Window had agreed to install windows in a commercial building for \$37,585. The windows leaked periodically over the next ten years, and Bee Window tried several times but failed to fix the problem. Finally, the owner brought suit to recover the cost of installing new windows from a different vendor, estimated to be over \$48,000. The Court of Appeals affirmed the trial court's award for the full replacement cost, even though it was higher than the original contract price<sup>23</sup> and the owner had the use of the windows, albeit in a defective state, for more than ten years.

The test Indiana courts have devised to limit the cost-of-cure formulation is to ask whether the defective performance can be remedied without unreasonable "economic waste," i.e., whether the cure would require substantial reconstruction or excessive costs.<sup>24</sup> This is a flexible standard, of course, and economic waste is not well defined in the case law. The court in *Willie's Construction* felt that the amount of basement reconstruction, which might include razing the entire house and refitting utility connections, did not amount to excessive waste.<sup>25</sup> The result was that the builder had to make a \$24,000 damages payment for a job that would only have cost a small fraction of that amount if it had been done in the first instance. At the other end of the spectrum is *City of Anderson v. Sailing Concrete Corp.*,<sup>26</sup> where the court refused to award \$590,000 needed to repair the plaintiff's land when the value of the land after repair would only have been \$270,000. It would constitute economic waste to require such a large payment for so little benefit.<sup>27</sup>

One of the unstated reasons courts tolerate the risk of overcompensating the plaintiff with a generous cost-of-cure measure of damages may be that many of the plaintiff's injuries are not compensable at all. Even if the Bakers did not use the \$24,000 to raze their house, for example, they still might not have received a windfall. They had to pay their attorney through a trial and appeal. They had to live in a house with lower basement ceilings for more than three years while the case was being decided, and they may have to live with this deficiency much longer if they choose not to raise the ceilings or sell the home. They probably endured some emotional stress and aggravation throughout the proceedings, and devoted much time and energy, possibly taking time off work, to prosecute the

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22. 698 N.E.2d 328 (Ind. Ct. App. 1998).

23. *Id.* at 330.

24. See *Clark's Pork Farms v. Sand Livestock Sys.*, 563 N.E.2d 1292, 1297 (Ind. Ct. App. 1990); *Sanborn Elec. Co. v. Bloomington Athletic Club*, 433 N.E.2d 81, 89 (Ind. Ct. App. 1982).

25. Economic waste is not well defined in Indiana. Other jurisdictions have described it as "the destruction of usable property," *Gold Rush Inv., Inc. v. G.E. Johnson Constr. Co.*, 807 P.2d 1169, 1174 (Colo. Ct. App. 1990); "substantial undoing of a contractor's work," *City of Charlotte v. Skidmore, Owings & Merrill*, 407 S.E.2d 571, 581 (N.C. Ct. App. 1991); and a situation where the cost of repair exceeds the original cost of construction, *Johnson v. Garages, Etc., Inc.*, 367 N.W.2d 85, 86 (Minn. Ct. App. 1985).

26. 411 N.E.2d 728 (Ind. Ct. App. 1981).

27. See *id.* at 734.

action. They may have even been planning to use the deeper basement for some particular purpose that had to be abandoned because of the defective construction. Moreover, if they choose to use the money to have the house razed and rebuilt, they will either have to move out or live in a construction zone for several months while the work is being done.

None of these injuries would have occurred if performance had been made as promised, yet most are probably not compensable under traditional contract rules. While the construction contract did provide for attorney's fees if the builder had to sue the Bakers, it did not provide for the reverse, so the Bakers had to pay their lawyer. Psychological injuries—living in a shallow basement, enduring emotional stress, and putting up with subsequent construction headaches—would likely be viewed as emotional harm not compensable unless the defendant acted fraudulently or the breach was accompanied by physical injury.<sup>28</sup> Any injuries resulting from not being able to use the basement as planned might be considered unforeseeable consequential damages.

The Bakers were fortunate that the cost-of-cure measure was high enough to offset some of these noncompensable types of harm. Most plaintiffs do not find the damages award so generous. The rest of this Article discusses ways to give the nonbreaching party a better chance at more complete recovery from the contract breacher.

## II. CONSEQUENTIAL DAMAGES

The measure of damages in contract cases is the loss actually suffered as a result of the breach.<sup>29</sup> Not all of the actual loss is compensable, however. The plaintiff must overcome three hurdles: (1) the damage must be the natural and proximate consequence of the breach,<sup>30</sup> (2) it must have been within the contemplation of the parties when the agreement was reached,<sup>31</sup> and (3) it must be proved with reasonable certainty.<sup>32</sup> In essence, the Indiana courts follow the rule of *Hadley v. Baxendale*,<sup>33</sup> awarding only those damages that may reasonably be supposed to have been in the contemplation of the parties at the time the

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28. See *supra* note 3; see also *Captain & Co. v. Stenberg*, 505 N.E.2d 88, 100 (Ind. Ct. App. 1987); *Little v. Williamson*, 441 N.E.2d 974, 975 (Ind. Ct. App. 1982). In addition, a plaintiff may recover emotional distress damages where "the defendant by extreme and outrageous conduct intentionally or recklessly caused severe emotional distress . . . or where the conduct causing the injury was inspired by fraud malice, or like motives." *Tacket v. General Motors Corp.*, 818 F. Supp. 1243, 1248 (S.D. Ind. 1993) (citations omitted).

29. See *Holloway v. Bob Evans Farms, Inc.*, 695 N.E.2d 991, 995 (Ind. Ct. App. 1998); see also *Burleson v. Illinois Farmers Ins. Co.*, 725 F. Supp. 1489, 1495 (S.D. Ind. 1989); *Ethyl Corp. v. Forcum-Lannon Assoc., Inc.*, 433 N.E.2d 1214, 1221 (Ind. Ct. App. 1982).

30. See *Finley v. Chain*, 374 N.E.2d 67, 76 (Ind. App. 1978).

31. See *Strong v. Commercial Carpet Co.*, 322 N.E.2d 387, 392 & n.2 (Ind. App. 1975).

32. See *I.C.C. Protective Coatings, Inc. v. A.E. Staley Mfg. Co.*, 695 N.E.2d 1030, 1037 (Ind. Ct. App. 1998).

33. 156 Eng. Rep. 145 (Ex. D. 1854).

contract was entered, as the probable result of its breach.<sup>34</sup>

The first hurdle—proximate causation—usually creates few difficulties. It essentially requires a showing that the breach was an actual contributing cause of the loss (i.e., causation in fact) with the losses flowing “directly and naturally from the breach.”<sup>35</sup> If it appears that the loss was in fact caused by the breach, but it was a remote consequence, the proximate causation inquiry melts into the second requirement—that the loss be reasonably contemplated as a probable result of the breach.<sup>36</sup> This is the issue given the most extensive treatment in the courts, and is the heart of *Hadley*. For example, in one case, recovery was denied to an individual who claimed damages from sickness and loss of employment when his insurance company denied payment under a fire insurance policy.<sup>37</sup> The court held that the injuries were too remote and thus not in the contemplation of the parties when they signed the home insurance contract.<sup>38</sup>

In other cases involving fire insurance, however, claimants have fared better. In one action, an individual sought damages arising from foreclosure on his mortgage after the insurance company refused to pay the claim.<sup>39</sup> The court stated that this financial loss was directly related to the company’s refusal to pay, and thus was more likely to have been within the contemplation of the parties as a probable consequence of a breach.<sup>40</sup> In another decision, *Indiana Insurance Co. v. Plummer Power Mower*,<sup>41</sup> a business claimed \$90,000 reimbursement for costs incurred in defending legal actions filed against it by creditors after the business location had burned down. The court upheld much of the award, stating that when a business owner contracts for insurance, he expects prompt payment

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34. See *I.C.C. Protective Coatings*, 695 N.E.2d at 1037; *Strong*, 322 N.E.2d at 392 n.2.

35. *Sammons Communications of Ind., Inc. v. Larco Cable Constr.*, 691 N.E.2d 496, 498 (Ind. Ct. App. 1998).

36. See *Strong*, 322 N.E.2d at 392 & n.2.

37. *Meridian Mut. Ins. Co. v. McMullen*, 282 N.E.2d 558 (Ind. App. 1972).

38. *Id.* at 566.

39. *Burleson v. Illinois Farmers Ins. Co.*, 725 F. Supp. 1489, 1489-90 (S.D. Ind. 1989).

40. *Id.* at 1496. The court ultimately denied recovery for consequential damages, however, on the ground that damages were limited to the maximum amount of the insurance policy. *Id.* at 1497-98. The Indiana Court of Appeals subsequently held that consequential damages in an insurance case can exceed the policy limits. See *Indiana Ins. Co. v. Plummer Power Mower & Tool Rental, Inc.*, 590 N.E.2d 1085 (Ind. Ct. App. 1992). Some commentators disagree and argue that no consequential damages should be recoverable if the insurer denies coverage in good faith. See ROBERT E. KEETON & ALAN I. WIDISS, *INSURANCE LAW—A GUIDE TO FUNDAMENTAL PRINCIPLES, LEGAL DOCTRINES AND COMMERCIAL PRACTICES* § 7.9(d) (1988). Although *Plummer Power Mower* has not been overruled on this point, the Indiana Supreme Court, in denying punitive damages absent bad faith denial of benefits, has stated that an insurer has a “right to disagree” and is “permitted to dispute liability in good faith because of the social costs of a rule which would make claims nondisputable.” *Erie Ins. Co. v. Hickman*, 622 N.E.2d 515, 520 (Ind. 1993) (quoting *Vernon Fire & Cas. Ins. Co. v. Sharp*, 349 N.E.2d 173, 180 (Ind. 1976)). See *infra* note 76 and accompanying text.

41. 590 N.E.2d 1085 (Ind. Ct. App. 1992).

so he can resume operations.<sup>42</sup> Delayed payment will “undoubtedly” result in the failure of the business, and the owner will not be able to generate enough income to pay creditors.<sup>43</sup> In the words of Judge Conover, “The likelihood of such damages is only unforeseeable to unreasonably narrow-minded insurers.”<sup>44</sup>

Proving that the losses were reasonably contemplated at the time of contracting, as a probable result of the breach can be difficult. The case usually turns on the court’s view of the expectations of the parties when the contract was made. Unfortunately, most contracting parties (and their lawyers) do not think much about the consequences of breach during the contract formation stages. Once litigation ensues, the plaintiff’s lawyer frantically tries to find some evidence that the defendant knew, or had reason to know, of the plaintiff’s particular circumstances and needs at the time the deal was made. Often, the initial correspondence between the parties will give some indication of the plaintiff’s needs. But typically, the only evidence is testimony about what the plaintiff told or showed the defendant about his business or his particular reasons for entering into the contract. These statements will usually be contradicted by the defendant, and the plaintiff might not carry his burden of proof. As a precautionary measure, though at the risk of over-lawyering, it may be advisable to document the expectations of the client during the pre-contract discussions, and make sure the other party is made aware of the client’s circumstances. Typically, the “recital” or “whereas” clauses at the beginning of a contract are an appropriate place to insert these contractual expectations.

If the causation and foreseeability problems can be solved, the third hurdle the plaintiff must overcome is establishing that the damages are supported by more than speculation or conjecture. Indiana courts will look for objective evidence. In *Showalter, Inc. v. Smith*,<sup>45</sup> the Smith family had contracted to sell several summer camps to Showalter. Following breach of the agreement by Showalter, the Smiths sought, inter alia, about \$29,000 in consequential damages for interest paid on outstanding debts that would have been retired had Showalter complied with the terms of the purchase agreement. Gary Smith testified that he would have used the sale proceeds to pay off the debts, and the trial court awarded the damages based on this uncontradicted evidence alone.<sup>46</sup> The court of appeals reversed, however, concluding that it could “only speculate as to whether Smith would have actually paid off these debts with the proceeds.”<sup>47</sup> Judge Shields, in dissent, accused the majority of placing its judgment of Smith’s

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42. *Id.* at 1092.

43. *See id.*

44. *Id.* Judge Conover continued, “Simply put, the insurer cannot look at an insured’s loss of livelihood and loss of home, shrug its shoulders, and hide behind the fact that in made an ‘honest mistake.’ Delay, whether in good or bad faith, has clearly foreseeable consequences.” *Id.* at 1092 n.6. The court denied recovery for some of the losses, however, because they did not appear to be caused by the late payment. *Id.* at 1092.

45. 629 N.E.2d 272 (Ind. Ct. App. 1994).

46. *See id.* at 276.

47. *Id.*

credibility above that of the trial court.<sup>48</sup> She would have affirmed the award as supported by competent evidence.<sup>49</sup>

Damages need not be proved with absolute or mathematical certainty.<sup>50</sup> Evidence is sufficient so long as it enables the jury to make a "fair and reasonable finding" as to the proper damages.<sup>51</sup> The problem is most acute when the plaintiff seeks lost profits resulting from the breach. A claim for lost profits almost always provokes a challenge that the plaintiff is engaging in speculation. The problem is compounded when the plaintiff is claiming that it would have earned profits from business activities that never took place. Indiana courts are not hostile to claims of lost profits, though some objective evidence must be presented. "Consequential damages may include lost profits, providing the evidence is sufficient to allow the trier of fact to estimate the amount with a reasonable degree of certainty and exactness."<sup>52</sup> The trial court has great discretion in determining whether to submit the question of lost profits to the jury, and the fact finder has broad discretion in determining the amount.<sup>53</sup> Moreover, where there is any doubt about the exact proof of damages, the uncertainty will be resolved against the wrongdoer.<sup>54</sup>

There are limits, of course. One may not recover for "loss of face" in the industry or loss of goodwill.<sup>55</sup> The injury must arise directly from the breach of performance at issue. This can be problematic in many contract situations, particularly employment agreements when the employee breaches a covenant not to compete, as illustrated recently in *Turbines, Inc. v. Thompson*.<sup>56</sup> Thompson left the company to start his own engine repair business and then began soliciting the company's customers in violation of a one-year non-compete clause. The trial court found that the company did not prove lost profits even though Thompson had done substantial business with company customers after he left.<sup>57</sup> In affirming, the appellate court stated that it "could not be sure whether the decline in [Turbines'] revenues was merely cyclical or was the product of Thompson's competition."<sup>58</sup> It was not enough to show the gross or net profits

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48. See *id.* at 277 (Shields, J., dissenting in part).

49. *Id.*

50. See *I.C.C. Protective Coatings, Inc. v. A.E. Staley Mfg. Co.*, 695 N.E.2d 1030, 1037 (Ind. Ct. App. 1998); *Turbines, Inc. v. Thompson*, 684 N.E.2d 254, 258 (Ind. Ct. App. 1997); *Farm Bureau Mut. Ins. Co. v. Dercach*, 450 N.E.2d 537, 541 (Ind. Ct. App. 1983).

51. *I.C.C. Protective Coatings*, 695 N.E.2d at 1037; *Jerry Alderman Ford Sales, Inc. v. Bailey*, 291 N.E.2d 92, 106 (Ind. App. 1972).

52. *Insul-Mark Midwest, Inc. v. Modern Materials, Inc.*, 594 N.E.2d 459, 466 (Ind. Ct. App. 1992), *aff'd in part and rev'd in part on other grounds*, 612 N.E.2d 550 (Ind. 1993).

53. See *id.* at 467 (citing CORBIN ON CONTRACTS 145-46 (1964)).

54. See *Pepsi-Cola Co. v. Steak 'N Shake, Inc.*, 981 F. Supp. 1149, 1160 (S.D. Ind. 1997).

55. See *Indiana & Mich. Elec. Co. v. Terre Haute Indus., Inc.*, 507 N.E.2d 588, 606-07 (Ind. Ct. App. 1987).

56. 684 N.E.2d 254 (Ind. Ct. App. 1997).

57. See *id.* at 258-59.

58. *Id.* at 257 (quoting trial judge).

Thompson had earned from his dealings with Turbines' customers; the company had to prove that its own reduced profits were attributable to Thompson's actions and not some other cause.<sup>59</sup>

The plaintiff is not likely to recover for losses attributable to contracts other than the one broken, i.e., contracts to which the defendant was not himself a party. One notable exception, however, is the *Insul-Mark* case.<sup>60</sup> Insul-Mark had contracted to purchase specially coated screws to be used in roofing materials. Insul-Mark was a distributor and intended to resell the screws to other buyers; Modern Materials apparently knew this. When Insul-Mark's buyers complained that the screws did not resist rusting as promised, Insul-Mark sued Modern Materials to recover, inter alia, damages for lost profits on the resale contracts, as well as lost profits on future contracts with the same resale customers and other potential buyers.<sup>61</sup> Insul-Mark introduced the testimony of an economist who explained how the company would have made profits from future sales if the coating had performed as promised, essentially attempting to quantify the "ripple effects" of the breach.<sup>62</sup> Modern Materials did not challenge the availability of lost profits on the particular resale arrangements immediately connected with its contract. It moved for summary judgment, however, with respect to all other claims for lost future profits to these resale customers and others.<sup>63</sup>

The court of appeals reached a compromise solution. It held that summary judgment was appropriate on the claims for lost future profits from customers who had not contracted to receive the defective screws.<sup>64</sup> These were deemed the equivalent of claims for loss of goodwill and business reputation. Summary judgment was reversed, however, on claims for future profits that might have been earned from the customers who had contracted to receive the screws.<sup>65</sup> The court would permit the trier of fact to decide whether Insul-Mark would likely have earned future profits from these customers in subsequent agreements, not only from the resale contracts connected with the screws at issue.

*Insul-Mark* is a good case for plaintiffs because it allows for the recovery of lost profits beyond those immediately expected from the contract that was breached. The key factor was the "objective" evidence of the plaintiff's economist, who quantified a continuing relationship between Insul-Mark and its customers. The lesson for plaintiffs' lawyers is to seek evidence of specific losses that can be directly traced to the contract, even if the losses do not arise from the contract in the first instance. If the evidence makes the losses appear to have resulted more from the expected contract performance than the general loss of goodwill or business reputation, the court may allow the fact finder to

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59. *See id.*

60. *Insul-Mark Midwest, Inc. v. Modern Materials, Inc.*, 594 N.E.2d 459 (Ind. Ct. App. 1992), *aff'd in part and rev'd in part on other grounds*, 612 N.E.2d 550 (Ind. 1993).

61. *See id.* at 466.

62. *See id.* at 467.

63. *See id.* at 466.

64. *Id.* at 468.

65. *Id.* at 467-68.

bring it into the damage computation.

Plaintiff's lawyers need to be careful, however, in pleading their case. The Seventh Circuit, in the highly publicized case *Creative Demos, Inc. v. Wal-Mart Stores, Inc.*,<sup>66</sup> reaffirmed Indiana law that lost profits are not recoverable under a promissory estoppel theory, regardless how certain the proof.<sup>67</sup> While profits can be sought for breach of the contract itself, if the prevailing theory is promissory estoppel, the remedy is limited to losses incurred in relying on the promise. This will not ordinarily include expectancy damages like lost profits.<sup>68</sup>

### III. PUNITIVE DAMAGES

For years, Indiana courts struggled to draw the line between breaches of contract that will support a punitive damages award and those that will not. Under a long line of cases, if the defendant not only breached the contract but acted with "malice," or engaged in conduct that was "tortious in nature"<sup>69</sup> or "oppressive," punitive damages could be awarded.<sup>70</sup> As the lower courts began to expand the reach of this doctrine to more and more "tort-like" conduct, the supreme court put on the brakes. In *Travelers Indemnity Co. v. Armstrong*,<sup>71</sup> the court heightened the burden of proof, requiring the plaintiff to prove malice, tort-like behavior or oppressive conduct by "clear and convincing evidence."<sup>72</sup> In 1993 the court went further and declared in *Miller Brewing Co. v. Best Beers of Bloomington, Inc.*,<sup>73</sup> that punitive damages would only be available when the plaintiff proves an actual tort.<sup>74</sup> Breach of contract coupled with malice, tort-like conduct or oppressive behavior, would not be enough.

Thus, the black-letter law in Indiana is that punitive damages are not available for breach of contract.<sup>75</sup> That will not stop lawyers from seeking punitive damages, however, when a contract has been breached and the client has been wronged. The focus of the case will now shift to proving the elements of a recognized tort, or arguing for the creation of a new tort.

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66. 142 F.3d 367 (7th Cir. 1998).

67. *Id.* at 369.

68. *See id.*

69. *See* *Utopia Coach Corp. v. Watherwax*, 379 N.E.2d 518 (Ind. Ct. App. 1978).

70. *See* *Art Hill Ford, Inc. v. Callender*, 423 N.E.2d 601 (Ind. 1981); *Arlington State Bank v. Colvin.*, 545 N.E.2d 572 (Ind. Ct. App. 1989). The plaintiff must provide evidence that the defendant's conduct was "inconsistent with the hypothesis that the conduct was the result of mistake of law or fact, honest error of judgment, overzealousness, mere negligence or other such noniniquitous human failing." *Dow Chem. v. St. Vincent's Hosp.*, 553 N.E.2d 144, 150 (Ind. Ct. App. 1990).

71. 442 N.E.2d 349 (Ind. 1982).

72. *Id.* at 362-63.

73. 608 N.E.2d 975 (Ind. 1993).

74. *Id.* at 984.

75. *Creative Demos, Inc. v. Wal-Mart Stores, Inc.*, 142 F.3d 367 (7th Cir. 1998); *USA Life Ins. Co. of Ind. v. Nuckolls*, 682 N.E.2d 534 (Ind. 1997).

The Indiana Supreme Court adopted the latter approach in 1993 when it held in *Erie Insurance Co. v. Hickman*,<sup>76</sup> that it would, for the first time, recognize the tort of bad faith breach of an insurance contract. Realizing that *Best Beers* had removed punitive damages from breach of contract claims, it followed the view of most states and created a new tort. In doing so, however, it set out a general standard for determining when a tort has been committed. There must be a breach of a legal duty. This duty is independent of any contractual duty and is imposed by law, although it can be related to, or arise out of, the contractual duty.<sup>77</sup> Whether a breach of the duty constitutes a tort, however, requires a judicial balancing of three factors: (1) the special relationship between the parties, (2) the reasonable foreseeability of harm to the person injured, and (3) public policy concerns.<sup>78</sup>

Applying this test to insurance contracts, the court in *Hickman* stated that Indiana has long recognized an implied legal duty in all insurance contracts that the insurer will deal in good faith.<sup>79</sup> There is a special relationship between insurer and insured, at times an arms length dealing between the parties, but sometimes a fiduciary relationship and at other times an adversarial one.<sup>80</sup> Harm to the insured is easily foreseeable when a valid claim is denied in bad faith, and public policy demands fair play between the parties.<sup>81</sup> Although the court did not determine the precise extent of the insurer's legal duty, it did state that the duty is breached when the insurer makes an "unfounded" refusal to pay policy proceeds, causes an "unfounded" delay in making payment, "deceives" the insured, or exercises any "unfair advantage" to pressure an insured into a settlement of his claim.<sup>82</sup>

The tort is not committed every time an insurance claim is erroneously denied, of course. An insurer may dispute liability or the amount of recovery in good faith, and the mere lack of diligent investigation of the claim is not enough to justify punitive damages. Moreover, even if the tort is committed, it does not give rise to punitive damages unless there is "clear and convincing evidence that the defendant acted with malice, fraud, gross negligence, or oppressiveness which was not the result of a mistake of fact or law, honest error of judgment, overzealousness, mere negligence, or other human failing."<sup>83</sup> Recent decisions reaffirm this heightened burden of proof. In *Creative Demos*, for instance, a jury award of punitive damages was overturned even though a Sam's Club

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76. 622 N.E.2d 515 (Ind. 1993).

77. See *id.* at 518. The court quoted from an early Twentieth Century case, *Peru Heating Co. v. Lenhart*, 95 N.E. 680 (Ind. App. 1911) ("[A] tort is one's disturbance of another in rights which the law has created, either in the absence of contract or in consequence of a relation which a contract has established between the parties.") *Id.*

78. See *Hickman*, 622 N.E.2d at 518.

79. *Id.*

80. See *id.*

81. See *id.*

82. *Id.* at 518-19.

83. *Budget Car Sales v. Scott*, 662 N.E.2d 638, 639 (Ind. 1996).

representative lied to the plaintiffs to obtain important proprietary information about running their business.<sup>84</sup>

These decisions make it more difficult to recover punitive damages in contract actions. Proving the elements of an established tort will usually be more difficult than showing that the defendant breached a contract with malice or oppression. There are traditional tort theories to consider, however, in many contract actions. Fraud or deceit might be proved when the breaching party has acted dishonestly while breaching the agreement. The plaintiff may be able to prove that the defendant entered into the contract not intending to perform, or misled the plaintiff into thinking she would perform, knowing that the contract would likely be breached. To prove the tort, the plaintiff will have to establish false or misleading statements, the defendant's knowledge of falsity, intent that the plaintiff rely on the misrepresentations, actual reliance, and resulting injury.<sup>85</sup> The tort of conversion might also be alleged when the defendant has not only breached, but unlawfully retained the plaintiff's property in doing so.<sup>86</sup>

An alternative is to seek expansion of tort law, as the plaintiff did in *Hickman*. It will be difficult to argue a tortious breach of an implied duty of good faith in all contracts because Indiana courts have steadfastly refused to recognize a general implied duty.<sup>87</sup> But other "special relationships," in addition to insurance, have been recognized as candidates for punitive damages in other jurisdictions over the years. Although the law in this area is changing rapidly, successful tort actions have usually involved plaintiffs with little or no bargaining power who are in a particularly vulnerable position if the defendant takes an unreasonably firm position. Claims in the past two decades have involved exploitation of an employment relationship,<sup>88</sup> breach of fiduciary duty (trusts and banking applications),<sup>89</sup> bad faith denial of the existence of a contract,<sup>90</sup>

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84. *Creative Demos, Inc. v. Wal-Mart Stores, Inc.*, 142 F.3d 367, 370 (7th Cir. 1998). *See also Colley v. Indiana Farmers Mut. Ins. Co.*, 691 N.E.2d 1259, 1261 (Ind. Ct. App. 1998).

85. *See In re Gerard*, 634 N.E.2d 51 (Ind. 1994). In fact, in one of the most celebrated punitive damages contract cases, the Indiana Supreme Court stated that the elements of fraud were arguably present in a breach of warranty action against an automobile dealer. *See Hibschan Pontiac, Inc. v. Batchelor*, 362 N.E.2d 845 (Ind. 1977).

86. *See Chaiken v. Eldon Emmor & Co.*, 597 N.E.2d 337, 345 (Ind. Ct. App. 1992) (holding that conversion is the knowing exertion of unauthorized control over the property of another).

87. *See First Fed. Sav. Bank of Ind. v. Key Markets, Inc.*, 559 N.E.2d 600 (Ind. 1990).

88. *See Monge v. Superior Court*, 176 Cal. App. 3d 503 (1986). *But see Tacket v. General Motors Corp.*, 818 F. Supp. 1243 (S.D. Ind. 1993) (refusing to allow punitive damages in employment contract).

89. *See G & N Aircraft, Inc. v. Boehm*, 703 N.E.2d 665 (Ind. Ct. App. 1998) (involving minority shareholder of closely held corporation against majority shareholder and corporation); *see also Wagman v. Lee*, 457 A.2d 401 (D.C. 1983).

90. *See Seaman's Direct Buying Serv. v. Standard Oil of Cal.*, 686 P.2d 1158 (Cal. 1984). The recent trend, however, is to retreat from the tort of bad faith breach of contract. In California (where the tort had expanded for years), the supreme court has now overruled *Seamans* and other leading decisions, limiting the tort to insurance relationships. *See Freeman & Mills, Inc. v.*

retaliatory refusal to pay back wages,<sup>91</sup> bad faith failure to expeditiously perform a contract,<sup>92</sup> willful and wanton breach of a loan commitment,<sup>93</sup> and a landlord's failure to honor commitments with reckless disregard of the tenant's rights.<sup>94</sup>

The Indiana Supreme Court is not likely to expand traditional tort law to accommodate more claims for punitive damages arising out of contractual relationships. *Best Beers* was an attempt to restrict punitive damages claims, and courts will be reluctant to move in the other direction. The test set out in the *Hickman* case, however, is worded generally enough that lawyers may in good faith allege tortious conduct in many cases where a "special" contractual relationship exists.

#### IV. ATTORNEY'S FEES

Indiana follows the American Rule, which prohibits an award of attorney's fees against the losing party even though legal costs are a foreseeable consequence of breach.<sup>95</sup> Absent a contract provision, statutory authorization, or common law exception, each party must pay his or her own attorney.<sup>96</sup> There are dozens of attorney's fees provisions scattered throughout the Indiana Code, and the statutes should always be researched to see if any apply to the case. A sampling of provisions referencing fees that may be pertinent to contract litigation include: declaratory judgment actions,<sup>97</sup> marketing contracts with agricultural cooperatives,<sup>98</sup> repairs of audio entertainment products,<sup>99</sup> bad checks,<sup>100</sup> confession of judgments in bills and notes,<sup>101</sup> trademark or trade name

Southwest Forest Indus., Inc., 900 P.2d 669 (Cal. 1995). See generally James Nehf, *Bad Faith Breach of Contract in Consumer Transactions*, in *GOOD FAITH IN CONTRACT—CONTEXT AND CONCEPT* 115 (Roger Brownsword et al. eds., 1999).

91. See *Caplan v. St. Joseph's Hosp.*, 188 Cal. App. 3d 1193 (1987).

92. See *Jardine, Stephenson, Blewett & Weaver v. United States Fidelity & Guar. Co.*, 91 F.R.D. 284 (D. Mont. 1981).

93. See *Podleski v. Mortgage Fin., Inc.*, 709 P.2d 18 (Colo. Ct. App. 1985), *rev'd*, 742 P.2d 900 (Colo. 1987).

94. See *Hilder v. St. Peter*, 478 A.2d 202 (Vt. 1984).

95. See *Salcedo v. Toepp*, 696 N.E.2d 426 (Ind. Ct. App. 1998); *Barrington Mgmt. Co. v. Paul E. Draper Family Ltd. Partnership*, 695 N.E.2d 135 (Ind. Ct. App. 1998); *Indiana Glass Co. v. Indiana Mich. Power Co.*, 692 N.E.2d 886, 889 & n.3 (Ind. Ct. App. 1998) (noting that attorney's fees not compensable as consequential damages under UCC § 2-715; also noting, however, that fees may be recoverable when incurred by a buyer in third-party litigation, e.g., in defense of personal injury action brought by third-party consumer).

96. See *Dotlich v. Dotlich*, 475 N.E.2d 331 (Ind. Ct. App. 1985).

97. IND. CODE §§ 34-14-1-10, -52-1-1 (1998).

98. *Id.* §§ 15-7-1-24, -26.

99. *Id.* §§ 26-2-6-4, -7.

100. *Id.* § 34-24-3-1.

101. *Id.* § 34-54-3-1.

actions,<sup>102</sup> continuing care contracts,<sup>103</sup> home improvement contracts,<sup>104</sup> breach of warranty in home construction,<sup>105</sup> conversion of property,<sup>106</sup> failure to pay employee wages,<sup>107</sup> distress sales,<sup>108</sup> lost or destroyed documents of title,<sup>109</sup> environmental marketing claims,<sup>110</sup> franchises,<sup>111</sup> conveyance of hazardous substances,<sup>112</sup> landlord and tenant security deposits,<sup>113</sup> lemon law,<sup>114</sup> mechanics liens,<sup>115</sup> unfair practices by motor vehicle dealers,<sup>116</sup> rental-purchase agreements,<sup>117</sup> deceptive consumer sales,<sup>118</sup> securities violations,<sup>119</sup> storage liens,<sup>120</sup> telephone solicitation contracts,<sup>121</sup> and termination of wholesale sales representative contracts.<sup>122</sup> The statutes must be read carefully, however, because they are often narrowly drafted, and some contain conditions or limitations.

Indiana courts recognize three general common law exceptions to the American Rule as well:

(1) Obdurate behavior: Courts use their equitable power to impose costs on defendants who behave in bad faith.

(2) Common funds: Courts use their equitable power to ensure that the beneficiaries of litigation are the ones who share the expense. This prevents the unjust enrichment of "free riders."

(3) Private attorney generals: Courts use their equitable power to insure the effectuation of a strong public policy.<sup>123</sup>

The obdurate behavior exception is the one most likely to be useful in a breach of contract action. Its parameters are codified in Indiana Code section 34-52-1-1, which authorizes an award of attorney's fees in any civil action as part

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102. *Id.* § 24-4-5-7.

103. *Id.* § 23-2-4-20.

104. *Id.* § 24-5-11.5-14.

105. *Id.* § 32-15-7-10.

106. *Id.* § 34-24-3-1.

107. *Id.* § 22-2-4-4.

108. *Id.* § 25-18-1-21.

109. *Id.* § 26-1-7-601.

110. *Id.* § 24-5-17-14.

111. *Id.* § 23-2-2.5-28.

112. *Id.* § 13-25-3-15.

113. *Id.* § 32-7-5-12.

114. *Id.* § 24-5-13-22.

115. *Id.* § 32-8-1-2.

116. *Id.* § 9-23-6-9.

117. *Id.* § 24-7-9-4.

118. *Id.* § 24-5-0.5-4.

119. *Id.* § 23-2-1-19.

120. *Id.* § 32-8-32-5.

121. *Id.* § 24-5-12-20.

122. *Id.* § 24-4-7-5.

123. See *St. Joseph College v. Morrison, Inc.*, 302 N.E.2d 865 (Ind. App. 1973).

of costs to the prevailing party,<sup>124</sup> if the court finds that the party (1) brought an action or defense that is "frivolous, unreasonable or groundless;" (2) continued to litigate after the claim or defense "clearly became" frivolous, unreasonable or groundless; or (3) litigated the action in bad faith.<sup>125</sup> The trial court's decision to award fees will be reviewed under an abuse of discretion standard.<sup>126</sup>

In addition, Indiana Appellate Rule 15(G) provides that a court can award additional money, including attorney's fees, to the appellee if it affirms the award or judgment.<sup>127</sup> The award under this rule is discretionary and may be ordered when the appeal is "permeated with meritlessness, bad faith, frivolity, harassment, vexatiousness or purpose of delay."<sup>128</sup>

Courts tend to apply these exceptions more often in favor of defendants who have had to defend against a frivolous action brought by the plaintiff, but awards to plaintiffs have been made as well when the defendant stonewalls or has no legitimate defense.<sup>129</sup> While there is some overlap with Rule 11 of the Federal Rules of Civil Procedure, precedent under the federal rule is not determinative. Under Indiana law, a claim or defense is "frivolous" if

(a) it is taken primarily for the purpose of harassing or maliciously injuring a person, (b) the lawyer is unable to make a good faith and rational argument on the merits of the action, or (c) the lawyer is unable to support the action taken by a good faith and rational argument for an extension, modification or reversal of existing law.<sup>130</sup>

"A claim or defense is groundless . . . if no facts exist that support the legal claim."<sup>131</sup> It is "unreasonable" if, "based on a totality of the circumstances, including the law and facts known at the time of the filing, no reasonable attorney would consider that the claim or defense was worthy of litigation or justified."<sup>132</sup> A finding of improper motive is not required.<sup>133</sup>

124. The common law obdurate behavior exception and the statutory rule are not coextensive, however. Courts have held, for example, that the common law rule does not apply to obdurate behavior by defendants, but the statute does cover defendant conduct. See *Mitchell v. Mitchell*, 695 N.E.2d 920, 924 (Ind. Ct. App. 1998); see also IND. CODE § 34-52-1-1 (1998).

125. IND. CODE §§ 34-52-1-1(b)(1) to (3).

126. See *Nelson v. Marchand*, 691 N.E.2d 1264 (Ind. Ct. App. 1998).

127. See *Young v. Butts*, 685 N.E.2d 147, 151 (Ind. Ct. App. 1997); see also IND. R. APP. P. 15(G) (1998).

128. *Orr v. Turco Mfg. Co.*, 512 N.E.2d 151 (Ind. 1987). See generally Donald Clementson-Mohr & Jeffrey A. Cooke, Comment, *Frivolous, Unreasonable or Groundless Litigation: What Shall the Standard Be for Awarding Attorney's Fees?*, 22 IND. L. REV. 299 (1989); Andrew W. Hull, Comment, *Attorney's Fees for Frivolous, Unreasonable or Groundless Litigation*, 20 IND. L. REV. 151 (1987).

129. The question whether attorney's fees should be awarded is to be decided by the court, not the jury. See *O'Neill v. Goar*, 622 N.E.2d 562 (Ind. Ct. App. 1993).

130. *United Farm Bureau Mut. Ins. Co. v. Ira*, 577 N.E.2d 588, 597 (Ind. Ct. App. 1991).

131. *Id.*

132. *Kahn v. Cundiff*, 533 N.E.2d 164, 170-71 (Ind. Ct. App.), *aff'd*, 543 N.E.2d 627 (Ind.

The obdurate behavior exception has some teeth. An example in a breach of contract case is *United Farm Mutual Insurance Co. v. Ira*.<sup>134</sup> Ira made a claim for medical benefits arising from a debilitating accident. To support his claim, Ira submitted the reports of two examining physicians who indicated that the injuries were caused by the accident. The company denied coverage, relying on a third report that raised questions about causation. When Ira ultimately prevailed, the trial court awarded attorney's fees, and the appellate court affirmed, finding that the insurance company's defense was not reasonable.<sup>135</sup> The third report was based upon a review of medical records only, and was made without examining Ira. Moreover, the report indicated that further investigation, including an examination, would be necessary to make a definitive finding. The company made no further effort to investigate the claim, choosing to deny coverage on the third report alone. The trial judge and court of appeals felt that this was too weak a basis for denying the claim and amounted to bad faith.<sup>136</sup>

A more predictable way to get the other party to pay attorney's fees, of course, is to provide for them in the contract. If the contract provides for attorney's fees, the provision will be enforced if it is not contrary to public policy.<sup>137</sup> This need not be a reciprocal obligation. A contract that only authorizes fees for one of the parties will be honored, though it will be reduced proportionately to the extent the opposing party prevails on a counterclaim.<sup>138</sup> Two recent cases illustrate, however, that recovery is by no means certain and fee provisions should be carefully drafted. *Salcedo v. Toepp*<sup>139</sup> involved the sale of a medical practice from Toepp to Salcedo. The transaction was embodied in several agreements, including an employment contract and lease. The documents each contained different language about attorney's fees. Toepp ultimately prevailed on an employment claim and successfully defended against Salcedo's claim under the lease. The trial court ruled that he was not entitled to attorney's fees under either contract.<sup>140</sup> The employment agreement only provided for fees to a prevailing party in an arbitration, and the parties chose not to arbitrate.<sup>141</sup> The lease provided that attorney's fees would be "added" to any judgment for a prevailing party, which the trial court interpreted to mean that there must first be a monetary recovery.<sup>142</sup> Because Toepp did not receive a money judgment in

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1989).

133. *See id.* at 171.

134. 577 N.E.2d 588 (Ind. Ct. App. 1991).

135. *Id.* at 597-98.

136. *Id.* at 595.

137. *See Barrington Mgmt. Co. v. Paul E. Draper Family Ltd. Partnership*, 695 N.E.2d 135, 142 (Ind. Ct. App. 1998).

138. *See Willie's Constr. Co. v. Baker*, 596 N.E.2d 958, 963-64 (Ind. Ct. App. 1992); *Burras v. Canal Constr. & Design Co.*, 470 N.E.2d 1362 (Ind. Ct. App. 1984).

139. 696 N.E.2d 426 (Ind. Ct. App. 1998).

140. *See id.* at 436.

141. *See id.*

142. *See id.*

defending Salcedo's lease claim, the trial court could not "add" the fees to anything. The court of appeals affirmed on the employment contract but reversed under the lease, finding that the agreement should be interpreted as providing for fees to a prevailing party who successfully defends an action on the lease even without a monetary recovery.<sup>143</sup>

A more troubling case is *Barrington Management Co. v. Paul E. Draper Family Ltd. Partnership*.<sup>144</sup> The parties entered into a written agreement for the sale of commercial real estate. The agreement provided that attorney's fees were recoverable to a prevailing party "in any legal or equitable proceeding against any other signatory brought under or with relation to the Contract or transaction . . . ."<sup>145</sup> The seller brought an action seeking rescission of the agreement when the buyer failed to fulfill certain conditions. At trial, the seller prevailed and the court granted rescission plus attorney's fees.<sup>146</sup> On appeal, the fee award was set aside. The court observed that a party may either affirm a contract, retaining all its benefits and seek damages, or rescind the contract, return all the benefits received and reinstate the status quo.<sup>147</sup> The seller's choice of rescission implied disaffirmance of the contract and all its contents, including the fee provision.<sup>148</sup> Because the plaintiff was suing for equitable rescission and not for breach of the contract, it could not claim the benefits of the contract.

*Barrington Management* seems wrongly decided. It certainly frustrates the intent of the parties in drafting the provision. The contract itself contemplated a fee award in legal or equitable actions, which would include an action for rescission. If the award cannot be made in an action to rescind the sale agreement, then the plaintiff is faced with either foregoing the equitable remedy or seeking fees. Indeed, if the court's view is correct, it would be impossible to get a fee award in any rescission action, absent statutory authorization or a common law exception. The decision is particularly curious because the buyer had counterclaimed for specific performance,<sup>149</sup> so the seller clearly was a prevailing party in the buyer's equitable action.

## V. PREJUDGMENT INTEREST

An award of prejudgment interest is often necessary to ensure that the prevailing party obtains the equivalent of full performance of the contract. If the defendant received goods but refused to pay the \$10,000 price, awarding the plaintiff \$10,000 three years later at trial is hardly the equivalent of having the

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143. *Id.*

144. 695 N.E.2d 135 (Ind. Ct. App. 1998).

145. *Id.* at 139 (quoting Purchase Agreement).

146. *See id.*

147. *Id.* at 142.

148. *See id.*

149. *See id.* at 135. The court apparently believed that the seller's action was unnecessary and that it would therefore be inequitable to award fees when the seller could have reached the same result without starting a lawsuit. *Id.* at 142-43.

use of \$10,000 for the entire three-year period. The purpose of prejudgment interest is to compensate fully for the lost use of money during the pendency of litigation.<sup>150</sup>

The standard for determining when a court should award prejudgment interest is easy to state but difficult to apply. The award in a contract case is warranted if the terms of the contract made the claim readily ascertainable and the amount of the claim rests upon mere computation.<sup>151</sup> The award is proper where the trier of fact "need not exercise its judgment to assess the amount of damages."<sup>152</sup> Precedent indicates that the award is not a matter of discretion in state courts,<sup>153</sup> and the court of appeals has viewed it as a matter of right when the elements are satisfied.<sup>154</sup>

The justification for the standard is that the award should only be made where it is clear that the losing party owed a specific, liquidated amount of money at an identifiable date in the past. The classic example is a contract for the sale of goods where the buyer, without justification, fails to pay the contract price when due. The court can look at the contract and determine exactly how much was owed, and when it should have been paid.

In practice, however, Indiana courts have awarded prejudgment interest even when the terms of the contract did not make the amount of the claim readily ascertainable by mere computation. In *Sand Creek Country Club, Ltd. v. CSO Architects, Inc.*<sup>155</sup> an architectural firm sued Sand Creek Country Club for its fees earned in making drawings for the expansion of the clubhouse facilities. The contract (in the form of a letter agreement) did not specify the contract price for services to be rendered, but it did include a general fee arrangement. The firm performed substantial services and submitted a bill for \$25,000, which the club did not pay. The firm subsequently sent another demand letter for \$33,649, the asserted "value" of all services rendered. The firm ultimately prevailed at trial, and the judge awarded the \$33,649 but no prejudgment interest.<sup>156</sup>

On appeal, the court upheld the damage award, but also found that the firm's demand letter made the damages "readily ascertainable" on the date it was delivered.<sup>157</sup> Prejudgment interest should therefore have been awarded from that

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150. See *Layden v. New Era Corp.*, 575 N.E.2d 638, 641 (Ind. Ct. App. 1990).

151. See *Firstmark Standard Life Ins. v. Goss*, 699 N.E.2d 689 (Ind. Ct. App. 1998); *Hooker Builders, Inc. v. Smalley*, 691 N.E.2d 1256 (Ind. Ct. App. 1998); *Gershin v. Demming*, 685 N.E.2d 1125 (Ind. Ct. App. 1997).

152. *Sand Creek Country Club, Ltd. v. CSO Architects, Inc.*, 582 N.E.2d 872 (Ind. Ct. App. 1991); *Monroe County Community Sch. v. Frohlinger*, 434 N.E.2d 93 (Ind. Ct. App. 1982).

153. See *Sand Creek Country Club*, 582 N.E.2d at 876.

154. See, e.g., *Dale Bland Trucking, Inc. v. Kiger*, 598 N.E.2d 1103 (Ind. Ct. App. 1992); cf. *DeLaCruz v. Pruitt*, 590 F. Supp. 1296 (N.D. Ind. 1998) (noting that prejudgment interest is matter of discretion in federal court).

155. 582 N.E.2d 872 (Ind. Ct. App. 1991).

156. See *id.* at 874.

157. *Id.* at 876.

time.<sup>158</sup> In dissent, Judge Garrard viewed the standard more rigidly. Because the price was not specified in the contract, damages were the "reasonable value" of services rendered.<sup>159</sup> This was not a liquidated amount despite the fact that the architectural firm asserted a specific figure in its demand letter.<sup>160</sup> One of the practical lessons of this case is that there is good reason to draft a demand letter as specifically as possible, itemizing the amount allegedly owed, in hopes of convincing the court that damages were liquidated and easily ascertainable at that point.

The standard for awarding prejudgment interest was virtually ignored in *Jordan v. Talaga*.<sup>161</sup> The plaintiffs alleged that a developer breached the implied warranty of habitability in the construction of their home because of excessive water seepage problems. The appellate court held that the appropriate measure of damages was the difference between the value of the home as warranted and the value at the time of acceptance.<sup>162</sup> Even though these damages clearly were not liquidated or readily ascertainable at the time of breach (requiring a comparison of market values), the court stated that an award of prejudgment interest would be appropriate "because the deprivation of the appreciation of one's house is substantially similar to the deprivation of the use of money."<sup>163</sup>

Another lesson from the case law is that prejudgment interest will likely be awarded if the parties have stipulated to the damages prior to trial. This will make it much easier for the court to conclude that the damages were liquidated and ascertainable from the time of breach.<sup>164</sup> This may be an additional incentive to encourage the defendant to stipulate to a damage amount early in the litigation whenever damages are not at issue.<sup>165</sup>

## VI. LIQUIDATED DAMAGES PROVISIONS

One way of ensuring a specific amount of compensation for breach of contract is to stipulate the damages in the contract. Care must be taken in drafting the provision, however, for at least two reasons. First, a liquidated damages provision can be a hindrance to full recovery if it stipulates too low an amount. The clause can work either for or against the party seeking damages.

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158. *See id.*

159. *Id.* (Garrard, J., concurring in part and dissenting in part).

160. *See id.*

161. 532 N.E.2d 1174 (Ind. Ct. App. 1989).

162. *Id.* at 1187.

163. *Id.* (citing *Fort Wayne Nat. Bank v. Scher*, 419 N.E.2d 1308 (Ind. Ct. App. 1981)).

164. *See Dale Bland Trucking, Inc. v. Kiger*, 598 N.E.2d 1103 (Ind. Ct. App. 1992); *cf. Hooker Builders, Inc. v. Smalley*, 691 N.E.2d 1256 (Ind. Ct. App. 1998) (finding that contractor had nothing in the record indicating that damages were readily ascertainable; damages did become ascertainable after arbitration award, however).

165. Prejudgment interest has traditionally been simple interest. If a party wishes to receive compounded interest, the contract should so provide. *See Firstmark Standard Life Ins. v. Goss*, 699 N.E.2d 689, 694 (Ind. Ct. App. 1998).

An example is *Beck v. Mason*.<sup>166</sup> The Masons entered into a contract to purchase real estate from the Becks. The sale contract provided that if the Masons fail to purchase, the Becks would retain a \$1000 earnest money deposit “as liquidated damages and not as a penalty or a forfeiture.”<sup>167</sup> After the Masons backed out of the deal, the Becks tried to recover more than the \$1000 because their actual damages were higher.

The court set out the rule in Indiana: A clause fixing damages in the contract does not per se restrict the remedies of the parties; where it appears that the parties so intended, the clause will be viewed as a minimum or alternative recovery, and the aggrieved party can sue for actual damages if they are greater.<sup>168</sup> On the intent issue, however, the court stated that by using the term “liquidated damages” the parties were demonstrating an intent to make the provision the exclusive remedy.<sup>169</sup> This construction “comports with the reasonable expectations of the contracting parties.”<sup>170</sup> The court went on to hold, in rather expansive language, that unless the language is ambiguous, a liquidated damages provision will be presumed to be the sole remedy for breach.<sup>171</sup> A party should be able to avoid this result by stipulating that the damages are supplementary only, or by merely requiring that the deposit be “forfeited,” without labeling the forfeiture a liquidated damages provision.

The second reason to draft a liquidated damages provision with care is to ensure that the court will not declare it an unenforceable penalty. The standard is not clearly enunciated in Indiana.<sup>172</sup> One formulation is that the provision is enforceable “where the nature of the contract is such that a breach would result in damages which are uncertain and difficult to prove, and the parties have fixed an amount that is not greatly disproportionate to the *loss likely to occur*.”<sup>173</sup> This two-part inquiry looks at the reasonableness of the provision as a predictor of likely damages, in light of circumstances known to the parties at the time the contract was made.

A second statement of the rule, however, focuses on the reasonableness of the provision in light of the actual damages sustained after the breach. The court will ask two questions:

- (1) Does the liquidating provision attempt to secure an amount for the non-breaching party which is reasonably proportionate to the amount of *actual damages* which will be sustained in the event of breach?
- (2) Is the provision designed to represent the measure of *actual damages*, or is it

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166. 580 N.E.2d 290 (Ind. Ct. App. 1991).

167. *Id.* at 291.

168. *Id.* at 293 (citing *Fletcher v. United States*, 303 F. Supp. 583 (N.D. Ind. 1967)).

169. *Id.*

170. *Id.* at 294.

171. *Id.*

172. *See Gershin v. Demming*, 685 N.E.2d 1125, 1128 (Ind. Ct. App. 1997) (“no hard and fast guidelines to follow”).

173. *Harris v. Primus*, 450 N.E.2d 80, 83 (Ind. Ct. App. 1983).

an apparent effort to penalize the breaching party so that the damages will be disproportionate to the *actual damages* sustained?<sup>174</sup>

Most commentators and courts agree that the first formulation is the most appropriate.<sup>175</sup> The clause should be upheld if it is a reasonable effort at estimating probable damages at the time the contract was consummated, regardless of the actual harm that follows the breach. In practice, however, it seems virtually impossible for courts to ignore the actual consequences of the breach, and this factor almost always colors the court's judgment regardless of the standard it purports to use. A recent example is *Gershin v. Demming*,<sup>176</sup> where the court examined a lease providing for damages equal to one percent of monthly rent per day for each day the tenant's payment is past due. The court stated that the clause will be upheld if the stipulated sum is "not greatly disproportionate to the loss *likely to occur*."<sup>177</sup> It then struck down the provision because it yielded a sum "grossly disproportionate to Landlord's *actual loss*."<sup>178</sup>

Another illustration is *Woodbridge Place Apartments v. Washington Square Capital, Inc.*<sup>179</sup> A real estate developer contracted for a \$4.6 million loan commitment from Washington Square Capital. The documents provided that if the developer did not go through with the loan, Washington would retain the developer's "standby deposit" of \$139,950, which was 3% of the loan amount and standard in the industry.<sup>180</sup> The loan was never funded, and the developer sued for return of the deposit. Judge Brooks viewed the standby deposit as a liquidated damages provision, and not as consideration for an option contract, and declared it an unenforceable penalty.<sup>181</sup> He acknowledged that there were uncertainties involved in predicting damages when a borrower backs out of a loan transaction, but struck down the provision because Washington introduced no evidence that the 3% figure was designed to estimate actual losses.<sup>182</sup> The amount seemed "arbitrary" and not reasonably proportionate to the amount of

174. *Czeck v. Van Helsland*, 241 N.E.2d 272, 274 (Ind. App. 1968).

175. *See, e.g.*, E. ALLEN FARNSWORTH, *CONTRACTS* 844-45 (3d ed. 1999). *Cf.* Melvin Aron Eisenberg, *The Limits of Cognition and the Limits of Contract*, 47 *STAN. L. REV.* 211, 225-36 (1995) (recommending a "second-look standard"). The UCC seems to sanction either approach, upholding the provision if the amount is "reasonable in light of the anticipated or actual harm caused by the breach." U.C.C. § 2-718(1). Regarding leases, UCC § 2A-504 speaks only of "anticipated harm." U.C.C. § 2A-504.

176. 685 N.E.2d 1125 (Ind. Ct. App. 1997).

177. *Id.* at 1127 (emphasis added).

178. *Id.* at 1129 (emphasis added). In another recent case, however, the federal district court did apply the "likely to occur" rule consistently. *See Miami Valley Contractors, Inc. v. Town of Sunman*, 960 F. Supp. 1366 (S.D. Ind. 1997).

179. No. EV87-204-C, 1991 WL 340619 (S.D. Ind. Jan. 10, 1991), *aff'd in part, rev'd in part*, 965 F.2d 1429 (7th Cir. 1992).

180. *See id.* at \*3.

181. *Id.*

182. *Id.*

actual damages.<sup>183</sup> Significantly, Washington failed to offer evidence of any substantial actual losses, other than some administrative costs for processing the paperwork. Indeed, there may have been no actual injury because Washington subsequently loaned the money to a different borrower at a higher interest rate. One suspects that if the actual losses had been higher (i.e., interest rates had declined), the clause would have been upheld.

One of the most common places to find a liquidated damages provision is in a covenant not to compete. *Turbines, Inc. v. Thompson*,<sup>184</sup> discussed earlier,<sup>185</sup> illustrates the reason why: It can be difficult to prove lost profits resulting from an employee's breach of the covenant. Indiana courts have sent conflicting signals on their enforceability, however. In *Raymundo v. Hammond Clinic Ass'n*,<sup>186</sup> the Indiana Supreme Court upheld a clause that required an orthopedic surgeon to pay \$25,000 if he breached a five-year commitment to work as a partner in a medical practice clinic. The contract included a covenant not to compete with the clinic following his departure. The court stated that it "will almost always uphold" a liquidated damages provision in a covenant not to compete unless the amount is "grossly disproportionate to the loss and far beyond any possible damages that could be incurred."<sup>187</sup> The court observed that it was altogether reasonable to assume that if Dr. Raymundo did not complete his five-year commitment, the clinic would incur the expense of finding a replacement as well as the loss of revenue.<sup>188</sup> In light of the fact that Dr. Raymundo was responsible for bringing in over \$100,000 in revenue per year, the \$25,000 damages provision was not excessive.<sup>189</sup>

In contrast, the court of appeals in *Hahn v. Drees, Perugini & Co.*,<sup>190</sup> struck down a liquidated damages provision in a contract between an accountant and an auditing firm. The agreement provided that if the employee terminated early and "perform[ed] any work in any manner for any fee whatsoever, for any client of the employer . . . [the employee must pay] three times the employers [sic] highest annual fee received from the client during the three most recent calendar years . . . ."<sup>191</sup> The court upheld the covenant in part, but held that the damages provision for breaching it was unenforceable.<sup>192</sup> It viewed the provision as an overbroad "shotgun clause" and therefore a penalty because it assessed treble damages regardless of whether the employee's contact with the firm's clients proved harmful in any way.<sup>193</sup> The contact might reduce the firm's income

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183. *See id.*

184. 684 N.E.2d 254 (Ind. Ct. App. 1997).

185. *See supra* note 56 and accompanying text.

186. 449 N.E.2d 276 (Ind. 1983).

187. *Id.* at 277.

188. *Id.* at 284.

189. *See id.*

190. 581 N.E.2d 457 (Ind. Ct. App. 1991).

191. *Id.* at 459.

192. *Id.* at 463.

193. *Id.*

greatly or hardly at all. The provision thus had no relationship to the injury the firm would likely suffer. Strictly speaking, the treble damages provision was not, in the language of *Raymundo*, "far beyond any possible damages that could be incurred." Taking a large auditing client away from the firm might cause a substantial loss of profits for many years. Nevertheless, the provision would seem to impose excessive damages in most instances, and there was no evidence of substantial actual injury. Besides, "treble" damages sounds punitive and more like a penalty for contract breach.

These last two cases illustrate the limits of liquidated damages clauses in employment contracts. When drafting such provisions, the lawyer should always ask whether he or she is legitimately trying to estimate actual losses or is merely creating a disincentive for the employee to terminate the contract. To increase the probability of enforcement, the clause should be drafted with language that shows a genuine attempt to predict future injury, recognizing the uncertainties in predicting what those injuries might be. Language suggesting a penalty for nonperformance should be avoided.<sup>194</sup>

#### CONCLUSION

Indiana case law is not unfriendly to plaintiffs in contract actions. Courts tend to give parties a great deal of freedom in drafting contract terms,<sup>195</sup> which can assist nonbreaching parties who planned ahead and then bring an action to enforce damage-enhancing provisions on the subject of liquidated damages and attorney's fees. Courts are not particularly strict in applying the standard for awarding prejudgment interest, granting the award even in cases where the damages were not "readily ascertainable" at an earlier date. Nor are they hostile to claims for consequential damages, including lost profits, so long as there is reasonably reliable, objective evidence to sustain them. While the current rules preclude punitive damages in contract actions, the *Hickman* standard for recognizing tortious conduct allows room for expansion in this area as well. In sum, Indiana remains a state in which good lawyering, from the contract drafting stage through litigation, can increase the chances of realizing full compensation, or at least something close to that amount, for a breach of contract.

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194. Using "penalty" language will not be decisive, however. In *Miami Valley Contractors, Inc. v. Town of Sunman*, 960 F. Supp. 1366 (S.D. Ind. 1997), the district court upheld a liquidated damages clause even though it provided that "a penalty shall be paid by the Contractor to the Owner" for late completion of the project. *Id.* at 1377.

195. See, e.g., *Trimble v. Ameritech Publ'g, Inc.*, 700 N.E.2d 1128, 1129 (Ind. 1998) ("Courts in Indiana have long recognized the freedom of parties to enter into contracts and have presumed that contracts represent the freely bargained agreement . . . . We continue to believe that 'it is in the best interest of the public not to restrict unnecessarily persons' freedom of contract.") (citations omitted).