

Dispute Resolution Factsheets

Pre-empting arguments over compensation: liquidation damages and penalty clauses in your contracts

Liquidated damages clauses are often used in construction projects - agreeing the level of compensation if the project overruns. Similarly, an outsourcing contract can include liquidated damages if the supplier fails to meet agreed service levels. Or an employment contract can include a 'no show' clause that requires a new employee to pay a fixed sum - liquidated damages - to his new employer if he changes his mind and decides not to start the new job he has agreed to take.

Negotiating compensation in advance and including it in the contract has several advantages:

- Both customer and supplier benefit from increased certainty. Damages which might otherwise be difficult to quantify, such as lost profits, are specified.
- The likelihood of **litigation** in case of breach of contract is reduced.
- The need to fulfil the contract is reinforced, reducing the risk of breach of contract.

Normally, terms freely agreed between two contracting businesses are enforceable. However, a liquidated damages clause will not be enforceable if it is a penalty.

- A liquidated damages clause that was a reasonable estimate of the probable loss is enforceable.
- A clause which attempts to intimidate the supplier into fulfilling the contract, rather than to compensate the customer for a breach, is a penalty.
- An unreasonable estimate is likely to be considered a penalty.
- Whether the clause is referred to as liquidated damages or a penalty is irrelevant.

How can I tell whether mine is a liquidated damages clause or a penalty clause?

Characteristics of a *liquidated damages clause* are:

- Reasonable estimate of the probable loss (regardless of what the actual loss turns out to be).
- Does not have to be a genuine pre-estimate, but should be justifiable.
- Reasonable at the time of entering into the contract rather than when the breach occurs.
- Negotiated terms are more likely to be considered reasonable than a liquidated damages clause that is unilaterally imposed.

Characteristics of a *penalty clause* are:

- Compensation that is clearly greater than the greatest possible loss that could be suffered as a result of the breach.
- In the case of failure to pay a specified sum, a larger amount than that sum.
- As much compensation for a minor breach of contract as for a major breach that causes significant damage.

Practical implications

- Any liquidated damages clause should be carefully drafted, to minimise the risk that it could be challenged as a penalty.
- Particular care should be taken where a liquidated damages clause is to be the only remedy for a breach of contract. If the clause is unenforceable, there may be no other way to claim compensation.
- Keep evidence of the negotiations to agree any liquidated damages clauses, and of the basis on which the amounts of compensation were agreed.

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Always **take legal advice** in a dispute involving a liquidated damages clause in your contract, or if you wish to include one in a contract you are negotiating.

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