**CARL SIMMS**
**DIRECTOR**
**HKA**

# Liquidated damages

Within commercial contracts the use of liquidated damages is a standard way of dealing with the possibility of a breach of contract. A liquidated damage is used to determine what one party will pay the other in the event of a specific breach of its obligations by way of compensation.

The advantages of liquidated damages clauses are clear from a commercial perspective and when combined with the principle of freedom of contract This is especially so in a commercial context, where the parties are free to apportion the risks between themselves. However, there have been times where unscrupulous contract drafters have attempted to draft liquidated damage clauses in a way which constitutes a penalty, therefore, such clauses will not be enforceable.

In some cases, the liquidated damage provisions are often only given a cursory glance at the formation of a contract as this is the point where, typically, the relationship between both parties is at its strongest and the thought of failing to meet a date in the contract is not considered. However, it is at this stage which offers the greatest chance for both parties to review and discuss the implications of the provisions. Generally, it is only when difficulties arise further down the line that a proper review of the liquidated damage clause is undertaken by the party liable to pay liquidated damages. Then there is a moment of dread which is swiftly followed by a phone call to the company director who exclaims “HOW MUCH?!”

**What are liquidated damages?**
Liquidated damages (also referred to as liquidated and ascertained damages) are predetermined damages that are typically agreed between the parties to a contract. Typically, these damages are to be paid upon a specific breach of the contract, for example, late performance.

Liquidated damages can be a fixed sum, for example, £1,000 for each day that the project completion is delayed. Alternatively, it could be 1% of the contract value per week of delay.

There are other damages that can be considered as part of a contract between parties, known as general damages or unliquidated damages. These are typically considered to be ‘at large’, meaning that the party who is attempting to seek the damage must prove their losses. This is considerably more difficult to prove than to have a predetermined damage such as a liquidated damage, where these damages are agreed prior to the execution of the contract.

**Can liquidated damages be claimed despite the other party not incurring any loss?**
In short, yes. It does not matter if the loss suffered is smaller or larger than the sum of the liquidated damage and importantly, the claiming party does not have to prove the actual loss.

The longer answer is, it depends on the construction of the liquidated damage clause, and the circumstances in which the liquidated damage is being claimed.

For a liquidated damage clause to be enforceable, and for it not to be considered as a penalty clause, the liquidated damage must be a genuine pre-estimate of loss. Therefore, the clause must not intend to penalise, but rather to compensate in the event of a breach. If it can be proven, on the balance of probabilities, that the liquidated damage is not a genuine pre-estimate of loss, and that the sum sought is extravagant and unconscionable in comparison to the actual loss, the liquidated damage may be considered a penalty.

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If a liquidated damage clause is held not to be a genuine pre-estimate of the loss, then the next thing to consider is whether there is a legitimate interest. If there is a legitimate interest, is it justifiable to require the defaulting party (the party in breach) to pay the sum in excess of the sum suffered? The answer is, yes. Even where a liquidated damage is more than the actual loss, it may still be enforceable: if the amount is not considered to be penal because there is a legitimate interest, if the interest justifies the liquidated damage; and the liquidated damage is not considered to be out of proportion.

**What is a legitimate interest?**
The term legitimate interest is broad in definition, the interests do not have to be very compelling, and it does not rule out interests that are more trivial. An interest that could be considered as trivial or controversial could still be a legitimate interest, although they are more easily disregarded.

Showing that there is a legitimate interest does mean that there must have some clear and specific benefit or outcome in mind. It is not enough to rely on vague or generic business interests.

What constitutes a legitimate interest and whether a contractual provision is proportionate to that interest, can only be determined on a case-by-case basis. The concept of proportionality is tied to the interest and this must be considered against what, if any, legitimate business interest is served and protected by a given clause.

**What can a legitimate interest cover?**
Legitimate interests can cover a broad range of interests, but in the contracts relating to rail, rolling stock and signalling, these interests may cover: profit; act as a deterrent or an attempt to prevent a breach of contract; or utilised as a way to manage the efficiency of resources.

**When do liquidated damages become payable?**
Liquidated damages are to be paid upon a specific breach of the contract e.g. late performance. Once a breach has occurred, the claiming party must notify the other party of its intentions to levy liquidated damages and then follow the procedure within the contract.

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**What if there are multiple milestones each with a specific breach?**
There is a presumption that when there is an occurrence of several different events (milestones) and the stipulated sum i.e. the liquidated damage, is the same for all, it could be argued that the liquidated damages are not a pre-estimate of loss. This is because some of the events will not cause an equal amount of loss. In this case, the stipulated damage for all events is not going to be considered genuine.

To resolve this issue, if there are different milestones within a contract, the parties should ensure that there is a liquidated damage for each to reflect what the loss would be if a delay occurs at that point in time.

**Considerations for future liquidated damage clauses.**
There is now a sense flexibility shown to liquidated damage clauses which act as a potential remedy. Penalties remain the greatest risk to the enforceability of these clauses. However, the courts are reluctant to intervene in the contractual relationship between experienced commercial parties - unless strictly necessary.

The focus on legitimate interest is worth bearing in mind and it may be sensible to expressly identify those interests in the contract.

It may also be sensible for parties to keep written notes of the background and reasons for choosing the sums they did. There is an increased awareness of the commercial background and justification underlying liquidated damage clauses and the context in which they are agreed.

**Points to consider when it comes to liquidated damages**

During the formation of the contract ensure that you carefully read, understand and can calculate the amount liquidated damages you may be liable for should the worst happen.

There is a general tendency in bespoke contracts for liquidated damage provisions to include an agreement where the manufacturer or supplier cannot challenge the validity of the liquidated damage amount once the contract has been signed. This will somewhat limit the ability to challenge liquidated damages that are considered.

Liquidated damages, within reason, do not have to be a genuine pre-determined estimate of loss.

Manufacturers and suppliers may want to ensure the liquidated damage is an exhaustive remedy for and not in addition to claim general damages for the same breach.

Seek a liability cap, if possible. Having a liquidated damage so high it undermines contract performance is in neither parties interest.

Confirm that should the overall contract value changes during performance, due to variations for example, that the liquidated damage does not change proportionately.

Where a manufacturer or supplier has been delayed by the customer or an event prescribed in the contract occurs be sure to submit the relevant notice and follow the correct procedures to make a claim for an extension of time.

Prior to liquidated damages being levied, there is typically a two-step process that must be followed: a notice setting out that the customer "may require payment of, or may withhold or deduct, liquidated damages"; and before the sums are deducted, the customer must issue a second notice under which the customer "requires" the manufacturer or supplier to pay liquidated damages.

If you require any further information, please contact Carl Simms at carlsimms@hka.com