

Commercial contracts:

Liquidated damages or a penalty clause?

A recent case changed the established test in relation to the enforceability of liquidated damages clauses. Liquidated damages clauses set out the pre-agreed level of compensation that is to be paid by a party in the case of a breach of contract.

The traditional test was an attempt to calculate a genuine pre-estimate of likely losses. If the clause sought to impose an obligation that was more than merely compensating for the loss (i.e. what is known as a penalty clause) it will be unenforceable.

The case in question dealt with the building of a luxury yacht. A liquidated damages clause provided that 20% of the contract price should be paid to the seller if the contract did not proceed and the remaining sums already paid be returned to the buyer. The buyer terminated the contract.

The judge in the case adopted what is known as “the commercial justification test” rather than the traditional test. This permits business or commercial reasons to be considered when interpreting the clause. The result was that even though the 20% figure was not a genuine pre-estimate of likely losses it was upheld and the buyer had to pay this sum to the seller.

This change in emphasis to commercial justification rather than a genuine pre-estimate of losses is significant and potentially significantly increases potential payments due under contracts for early termination.

Therefore, when negotiating a contract which includes a liquidated damages clause, the following should be borne in mind:

- Clearly record in writing why a specified amount has been agreed upon and continue to try to explain why it is the genuine pre-estimate of losses likely to be incurred.
- A clause that attempts to provide compensation for both parties is more likely to be upheld. In this case, the fact that any amount over and above the 20% figure would be returned to the buyer helped the seller’s argument.
- Other options should be considered and records should be kept as to why they were not used.

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