

Liquidated damages and the recent change in law

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What are liquidated damages?

Two parties agreeing terms in a contract sometimes provide that if Party 'B' breaches the contract or fails to perform its obligations in favour of Party 'A', Party B pays a pre-agreed amount as damages ('liquidated damages') for a specific breach. Such clauses make it easier and quicker to recover money. Parties A and B do not have to argue over elements of the losses, the liquidated damages clause can simply be activated to determine the pay-out. However for any such provision to be fair, it is subject to a test, i.e. whether or not it is a penalty. The courts dislike penalty clauses.

The Cavendish case

The courts in England and Wales have always maintained that the law with regards to liquidated damages will be subject to the rule on penalties, primarily for public policy reasons. This remains the case following the most recent case of *Cavendish Square Holding BV v Talal El Makdessi (Cavendish) and Parking Eye Limited v Beavis (ParkingEye) (joint appeals) [2015] UKSC 67*.

The test for ascertaining whether a liquidated damages clause is a penalty has been subject to both narrow and wide interpretations – the commonly used term 'a genuine pre-estimate of loss' applied historically gave way to considerations such as whether provisions were 'extravagant and unconscionable', some judges nevertheless considering these terms ambiguous. The courts then considered the commercial justification of parties' agreed terms.

The current law following this Supreme Court case shifts the focus away from the principle of a genuine pre-estimate of loss, towards safeguarding 'legitimate interests'. Provisions that are 'punishments' are seen as penal. The concepts of extravagance, unreasonableness and deterrence are considered in the context of whether or not a provision is a penalty.

The Cavendish and ParkingEye cases, while offering a new test based on primary and secondary obligations, set out very similar principles covered in the previous case law. There are some slight variations on the theme between the majority judgments from the seven judges who dealt with this case. The Supreme Court's ruling however does not (unfortunately) offer a simple solution to contracting parties.

The current test

The current test is to ascertain whether the liquidated damages clause is a 'secondary obligation' which imposes a detriment on Party B (the 'contract breaker') out of all proportion to any legitimate interest of Party A (the 'innocent party') in the enforcement of the 'primary obligation'. Clearly a technical (far from 'user friendly') test, for contracting parties to understand and apply.

To clarify with an example, the primary obligation can be a clause dealing with late completion of works, breach of which can result in a price adjustment mechanism (designed to protect Party A's goodwill or business interests), and not related to compensating for failure to complete on time as such. It is possible that this price adjustment can be seen to have a legitimate function that unrelated to punishment, but one that protects Party A's commercial objectives. In our view the latest test has in fact widened the law in favour of contracting parties reaching agreement on matters, such that where there is a true bargain between the parties, the court is more likely to assume that a provision is a commercial agreement and so not a penalty.

The law in this area will however continue to evolve and we expect time will clarify further how this new test will apply in practice. In the meantime, we expect that contracting parties will need to consider clauses that seek to impose liquidated damages carefully, both with their advisors and with the other contracting party. It will be prudent for example for Party A to consider with Party B what Party A's legitimate business interests are, when determining the appropriate sum payable by Party B for a breach, or for agreeing a commercial term (e.g. price adjustment). Party A must also consider with its advisors whether such an obligation is extravagant, exorbitant or unconscionable, taking account of Party A's interest in the performance of the contract. What is apparent is that there is no one solution. Each project, each obligation, and each client's circumstances will need to be considered on a case by case basis.