LIQUIDATED DAMAGES

When is a penalty not a penalty? By **Tom Grant** of Harris Hagan.

To paraphrase Basil Fawlty, "Don't mention the word 'penalty'. I mentioned it once but I think I got away with it". In the context of negotiating liquidated damages clauses in commercial contracts, it is advisable to apply equal caution to use of the word 'penalty' as it would be to reference 'the war' when hosting German hotel guests in Torquay.

Liquidated damages have become an increasingly popular way of dealing with the prospect of breach and the appropriateness of applying liquidated damages has become a significant feature of commercial negotiations. In the context of gambling-related contracts, this discussion can arise in many situations but most commonly in relation to the delivery of a white-label website, software development agreements or in the use of service credits. Commonly, the discussion between the parties will start as follows:

Solicitor A: "We will need to consider introducing the concept of some liquidated damages as a pre-estimate of my client's losses in the unlikely event that your client fails to deliver the game on time."

Solicitor B: "My client won't agree to any liquidated damages and, in any case, you're effectively proposing a penalty clause which would be unenforceable." And so the debate goes on...

Advantages of liquidated damages clauses

There are some very obvious advantages to liquidated damages clauses for both parties. For the non-defaulting party, it is a shortcut remedy that avoids the financial and emotional baggage that comes with pursuing an ordinary claim for damages. For the party who may have some concerns about meeting its delivery obligations, liquidated damages focuses the mind and assures them of the extent of the financial implications of committing a breach. For both parties, it provides a practical way of dealing with minor breaches without irreparably damaging the commercial relationship. One could argue, however, that negotiating damages provisions at the outset hardly inspires mutual confidence and is not necessarily the healthiest starting point when embarking on a relationship.

Criteria for enforceability

In order to assess the question of enforceability, one has to look at the wealth of available case law, not the least the original authority on the matter of *Dunlop Pneumatic Tyres Co Ltd v New Garage & Motor Co Ltd* [*1915*]. This case set out four fundamental questions in assessing whether or not a clause requiring payment by a defaulting party was allowable as liquidated damages or unenforceable as a penalty clause:

1. If the stipulated sum is "extravagant and unconscionable" in comparison to the greatest loss that could conceivably be proved to flow from the breach, then it will be construed as a penalty.
2. If the breach relates to non-payment of a financial sum and the sum stipulated is greater than the sum which ought to have been paid, then it will be construed as a penalty.
3. If the entire sum becomes payable by way of compensation on the occurrence of one or more breaches, some of which may be minor, then it will be construed as a penalty.
4. The consequences of the breach are almost impossible to properly assess, then the pre-estimate may be construed simply as a true bargain between the parties.

More recent case law in 2013 supports many of these points. In *El Makdessi v Cavendish Square Holdings* [*2013*], the question of quantum was a key issue and underlined the fact that liquidated damages provisions must reflect the loss that is likely to be suffered. In many respects, this will be an evidential test as to whether there is a large disparity between the damages payable under the liquidated damages clauses and the damages actually suffered. Generally speaking, the Courts find it hard to commercially justify any significant disparity. Having said that, the process and calculations by which the level of liquidated damages has been arrived at does not need to be precise. The Courts accept that this is not likely to be an exact science and so will consider the expectations of likely damage at the time that the contract was made, rather than how it measures against the actual loss suffered at the relevant date. A generous margin for error is usually allowed and there must be a substantial discrepancy between the level of damages in the contract and those actually suffered to conclude that the pre-estimate was so unreasonable as to represent a penalty. In doing so, the Courts will consider the pre-estimate in the overall context of the commercial agreement and the negotiations, rather than the precision of the initial calculation.

Game development

Liquidated damages are commonly sought by operators when contracting with a game developer to design a new game. Launch of the games can often be time critical, not least when the theme and launch date is tied to a particular event, such as a new series of a television programme for which the licensed assets are being used in a slot game or a themed bingo room. In these circumstances, the payment of liquidated damages will be pitched in time for delays in successful completion of the acceptance testing procedure. Software developers will often seek to provide that the customer's only remedy for delay is the payment of demonstrable reasonable costs. This creates a difficulty for operators in determining the sum that is a genuine pre-estimate of its loss. In these circumstances, operators should be able to use their experience of launching new games to estimate likely revenue loss, although the marketing impact of missing a launch date is harder to quantify.

Are service credits enforceable?

Whilst many assume that liquidated damages assume the form of an express clause, their more subtle form can be commonly found in service level agreements and the concept of service credits. It is with good reason that they are termed "service credits" when, in fact, they could be capable of being "service penalties". Service level agreements are particularly common in the gaming industry – the nature of the commercial terms and the supply chain usually means that there is an ongoing relationship between platform providers, game suppliers and operators, invariably based on revenue share structures. Once again, the fundamental objective should be to ensure that service credits are fixed at a level that reflects a genuine pre-estimate of loss resulting from the supplier's inability to meet the relevant service level. Furthermore, it is often the case that performance of the service levels by the supplier may be reliant in some part on compliance by the customer, notably in relation to reporting problems, following escalation procedures and attending any project management meetings. There are increasingly inventive ways of balancing the scales with service levels and credits. For example, the supplier might have an opportunity to earn back service level credits based on annual performance or to attain a service level bonus for consistently strong performance. By introducing incentivised service levels for suppliers, the existence of service credits are less likely to be considered to be liquidated damages if they are capable of rewarding good performance as much as preventing bad performance.

Protecting the clause

It is, of course, always the case that a dispute will be judged on its own merits but the approach of the Courts is generally to uphold liquidated damages clauses wherever possible. There are several key steps that should be taken to ensure that a clause is a genuine liquidated damages clause capable of enforcement. In particular, the party seeking protection from the relevant clause should take the following steps:

1. Consider whether the sum being negotiated is "extravagant and unconscionable" when compared with the likely losses of your supplier's failure to deliver. Negotiating liquidated damages clauses should not be treated as a points-scoring exercise but as an authentic attempt to capture the cost of non-compliance. The Court is likely to construe an intimidatory payment of money intended to deter a party from breach as a penalty.
2. The contract should contain an express statement that the liquidated damages sum is a genuine pre-estimate of costs and is not a penalty. Clearly, this will not be definitive but, in the context of a negotiated contract between fairly balanced parties, it could be influential.
3. Keep written records from contract negotiations reflecting why and how the sum was arrived at. This will provide evidence (if needed) that it was intended to be a genuine pre-estimate of likely losses and that due consideration was given to the potential unenforceability of penalty clauses, which could ultimately prove persuasive, not least where the extent of the losses are difficult to assess.

If negotiated with sincere intent and drafted clearly and properly, liquidated damages clauses can be an effective and enforceable provision to frame expectations and to focus the minds of the supplier in a positive way. That is not to say, however, that it would be immune from challenge but customers should be mindful that over-egging the level of liquidated damages has the potential to backfire. Equally, suppliers will find it difficult to cry foul when the innocent party invokes the liquidated damages clause if it has been properly considered, fairly negotiated and is broadly commercially justifiable.

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