CORPORATE MATTERS:
SHOULD A LIQUIDATED DAMAGES CLAUSE BE INCLUDED IN A CONTRACT?

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WHAT ARE LIQUIDATED DAMAGES?

Liquidated damages are an amount of predetermined damages stipulated in a contract that can be recovered following the occurrence of an event set forth in the contract. A liquidated damage clause in a contract is an attempt by the parties to estimate damages in the event of non-performance or breach of the contract. The clause is typically used in circumstances where damages are hard to quantify, and it will be enforced by the courts where it is found that the harm caused by the breach is not only difficult to estimate, but also where the amount of liquidated damages is reasonable compensation in the circumstances and not disproportionate to the actual or anticipated damage. The intent of a liquidated damages clause is simply to measure damages that are hard to prove once incurred.

SHOULD YOU INCLUDE THE CLAUSE IN A CONTRACT?

Liquated damages clauses, if correctly drafted, can be an effective way of keeping parties to a contract out of court following a breach. Clients commonly like to include arbitration clauses in contracts to keep disputes out of court. Their rationale is that if there is a dispute, arbitration is quicker and less expensive; procedural steps and timelines can also be included in the contract.

Clients of this mind often also like liquidated damages clauses. The contract can state that if “X” event occurs, the parties agree that “Y” amount shall be paid as liquidated damages. If there is a breach, the amount of damages is set and the non-defaulting party does not have to go through the time-consuming and potentially expensive process of proving actual damages.

The amount of liquidated damages stated in the contract is supposed to be the parties’ best estimate as of the date of the contract of the amount of damages that would result from a breach. Clients appreciate this level of certainty. The alternative is leaving the amount of damages up to a court to decide, which, aside from the cost, has a high level of unpredictability.

ENFORCEABILITY

Care must be taken in drafting the clause, however, as the courts have held such clauses to be invalid when they end up imposing penalties rather than reasonable damages. A penalty is usually disproportionate to the actual harm. Where damages are easy to estimate, it may not be appropriate to use a liquidated damages clause. Generally, for a liquidated damages clause to be enforceable, the damages should

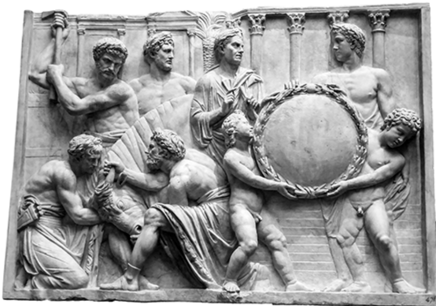
be either uncertain or difficult to quantify at the time the contract was entered into.

Furthermore, simply stating in the contract that the damages are liquidated and not a penalty will not necessarily make it so.[1] If the liquidated damages are found to be disproportionate, they can be declared a penalty rather than damages and the clause rendered invalid. If this happens, recovery will be limited to the actual damage that resulted from the breach.

Relevant factors to be considered in determining what is reasonable under the circumstances may include the following:

- What the parties knew about what might occur in the event of a breach
- The extent to which the amount of damages is described and justified in the contract
- The relative bargaining power of the parties
- What the parties were thinking at the time the contract was entered into
- Whether the clause was simply included in the "boilerplate" clauses or actively negotiated by the parties

Liquidated damages clauses give the parties to a contract some certainty and provide a form of self-insurance in the event of a breach. Each party knows the cost of breaching the contract and can weigh that against the cost of performance.



[1] Restatement (Second) of Contracts, §356 cmt.c (1981).

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