

# Liquidated Damages: A useful tool, but treat with caution...

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Liquidated damages (or "LD") clauses are a common feature in technology contracts, whether it's an agreement for the development of a mobile app or a piece of software, or an agreement relating to the outsourcing of IT functions. However, whilst they can be a useful tool, it's important they are treated with care to ensure that unintended consequences are avoided.

## Typical 'use-cases' for LD clauses

LD provisions come in handy in software development and implementation agreements; they can (for instance) provide the supplier with extra motivation to achieve 'service readiness' in line with agreed timescales. In the outsourcing arena, LD provisions can be included in the outsourcing contract in the form of a service credit regime, under which the customer receives a 'credit' in the event of the supplier's poor performance (and do keep an eye out for a note later on in this series on service levels and service credits.).

## Why should I include an LD clause?

Ordinarily, if a party to a contract breaches that contract, then the 'innocent' party will be able to pursue a claim for damages. However, it's possible (and often advantageous) to agree in advance the amount that would be payable in the event of a specified breach. Doing so creates greater certainty, and circumvents a number of the hoops that need to be jumped-through when claiming for damages through the courts - e.g. the innocent party will not have to prove actual loss. Not only that, LDs may be treated as a debt, so should be easier to enforce, and agreeing remedies in advance may help to avoid the contractual relationship being completely broken if a breach does occur.

## What should the 'number' be?

If you are looking to include an LD clause, it is crucial (irrespective of how the clause is structured) that you carefully consider the level of payment that will be triggered. This is ultimately a commercial question, however you should always bear the following in mind in the context of the relevant circumstances:

- If the number is **too high**, then there is a risk that the clause will drift into the realms of being punitive, rather than just acting to compensate the innocent party. This can result in the clause being deemed a penalty, and therefore unenforceable (see more on this below).
- If the number is **too low**, the clause could be construed as a cap on liability, in which case it will (depending on the nature of the agreement) be subject to the rules on limitations / exclusions of liability - as a result the clause could be deemed unenforceable, depending on the number.

## What is a penalty?

Where a contractual term requires payment of a particular sum in the event of a breach of that contract, the clause will be subject to the rule on penalties. In short, an LD clause will be deemed a penalty if: the payment in question is triggered by a breach of contract; and if it provides for a remedy which is out of all proportion to the innocent party's interests it is attempting to protect, the key point being that it is not acceptable to include a provision with the sole aim of punishing the party in breach.

## General rule: take time to consider the 'commercials', and draft carefully

The law that sits behind LD clauses is complicated, so when including them in a contract, it's critical that: (a) you give careful thought to how they are structured and the payment that will be triggered; and (b) the drafting is as 'tight' as possible to ensure the clause has the desired effect - this second point has been highlighted in a recent Court of Appeal case in which clumsy drafting had unintended consequences, meaning that the party wishing to rely on the clause effectively missed out on LDs that it would have otherwise been able to claim had the clause been drafted more carefully.

To discuss anything covered in this update, or technology contracts more generally, please contact Alistair Cooper or your usual DACB contact.

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