



Liquidated Damages

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Introduction

IT projects usually have a degree of urgency, but certain projects have activities which are vitally important, or at least on the critical path to achieve 'go live' in a timely manner. The question therefore arises from a customer's perspective, as to how to try to ensure the supplier's compliance with such timelines. One possible solution, is to introduce liquidated damages (ie payment of a pre-agreed amount by the supplier to the customer, if a milestone is not achieved), as an incentive to focus attention on the achievement of such timelines. The introduction of such a concept into a contract is not without its challenges, as it is necessary to address the competing considerations of the customer and the supplier in relation to this.

The topic of 'liquidated damages' therefore forms the subject matter for this month's Technology Column.

Legal and Business Considerations

From a customer's perspective, liquidated damages have the distinct advantage of:

- Incentivising the supplier's performance of the contract in accordance with particular timelines;
- Ensuring that damages are pre-calculated to minimise time and cost in calculating them;
- Providing a mechanism for payment of damages, without the burden of proving the loss and quantum through Court proceedings.

From a Supplier's perspective, liquidated damages add an additional layer of risk and liability.

However, liquidated damages are workable, as long as there is a reasonable approach adopted in formulating them and thinking through the associated consequences.

The Quantum of Liquidated Damages

The important point to bear in mind, is that for liquidated damages to be enforceable, they must be a genuine pre-estimate of loss rather than penal in nature, in accordance with general principles of English law. A customer may in fact wish to re-iterate this point, by including a provision in the contract that the liquidated damages are exactly this, ie a genuine pre-estimate of loss, so that if the supplier subsequently attempts to challenge the liquidated damages as a penalty, the customer can raise the reference to such an agreed provision in the contract. The inclusion of such a provision of itself will not guarantee that the liquidated damages will be held to be non-penal in nature, but it may

liquidated damages will be held to be non-penal in nature, but it may be persuasive, if there was a logical method of assessing the damages beforehand, and if the supplier did not challenge the inclusion of such a provision.

This is where the first point of contention therefore arises between a customer and a supplier, namely the amount of the damages. It is important for both parties to talk through the calculations for such damages, and understand which types of losses are being incorporated. A 'kitchen sink' approach is clearly not going to be conducive to reaching agreement, especially if certain heads of losses are expressly being excluded under the contract, but are then being attempted to be incorporated by the customer into the amount of the liquidated damages.

The Milestones Triggering Liquidated Damages

The amount of losses which are going to accrue to the customer at different points of the contract for late performance, are likely to differ across the timeline. Therefore, there is some 'averaging' which must be taken into account, if the same formula is going to be used in a uniform manner.

It is also important to consider the number of milestones which attract liquidated damages. Again, it is not conducive to attach liquidated damages to every timing event referenced in the contract. The parties must therefore determine which timing milestones are critical for performance, the failure of which is likely to result in a cost impact for the customer, or result in the inevitable failure to meet the 'go-live' date.

'Earn-back' or Retentions

To help achieve a compromise, thought can be given to either having the liquidated damages acting as a 'retention of payment obligations,' so that the payment is eventually released once performance of the respective milestone is achieved (provided that this is achieved within a certain additional time period), or there is an opportunity to 'earn back' the liquidated damages if the supplier is able to align the remainder of the timeline to the original timescales (for example by including additional resource on the project). It will be very much a case by case decision, as to whether this type of arrangement is an appropriate one or not, based on the nature of the project, the criticality of performance in accordance with the timelines, and the real consequences for the customer for such performance not being undertaken in a timely manner.

Sole & Exclusive Remedy

Another contentious issue arises, when one considers that since the liquidated damages are supposed to be a pre-estimate of loss, a supplier will usually wish to make it clear that such damages constitute a sole and exclusive remedy, so that the customer may not additionally claim damages or other remedies in the event that such liquidated damages are paid in the respective circumstances. From a customer's perspective, this might not be a position which it is willing to accommodate, as the damages that the customer may suffer, may be greatly in excess of the actual amount of liquidated damages which have been introduced in the contract.

However, a supplier will want the certainty that when it has paid an amount by way of liquidated damages, that it has absolved its liability in relation to that timing delay.

We therefore consider below, possible ways of addressing these competing requirements of the parties.

Capping the Liquidated Damages

The supplier may wish to limit the amount of liquidated damages to an aggregate cap. This needs careful consideration from a customer's perspective. There will be a cap on the aggregate liability of the supplier under the contract. If the supplier is looking to impose an express sub-cap in respect of total liability for the amount of liquidated damages payable, one needs to bear in mind, that there is already an implicit sub-cap which will apply automatically in terms of the amount of liquidated damages which are applicable on each trigger of the liquidated damages – ie the daily, weekly, monthly or quarterly amount (depending upon the time period in respect of which liquidated damages are payable). Imposing an additional express sub-cap, gives rise to the inevitable question, as to what happens when this sub-cap becomes exhausted.

Let us consider the position where a supplier wishes to impose an express sub-cap, in respect of the total liquidated damages payable by it, equating to 20% of the contract value, with the qualification that this represents a sole and exclusive remedy for the customer. How can it be reasonable for the supplier to then have continued late performance after the exhaustion of the express sub-cap, with the customer having no additional remedies available? Furthermore, what prevents the supplier in such circumstances, from simply failing to fulfil further performance, on the basis that the customer has already had its entire remedy in respect of such late performance?

From a customer's perspective, one therefore needs to consider the following, and reflect appropriate provisions in the contract:

- Does the way the sole and exclusive remedy is worded, still permit claims for certain additional express contractual performance warranties?
- Should the sub-cap be avoided, so that liquidated damages should be capable of being accumulated up to the aggregate limit of liability under the contract?
- Should certain circumstances allow an additional damages' claim, for example if the supplier has deliberately or recklessly avoided the need for compliance with the timelines?
- Should certain liquidated damages in respect of certain milestones be sole and exclusive remedies, but certain vital milestones (for example 'go live') have the ability for the customer to also claim damages in respect of the non-compliance with those particular milestones?
- If an express sub-cap is going to be introduced, should the exhaustion of the sub-cap permit the customer to either have the ability at that stage to claim damages for any further losses and/or terminate the contract for convenience or cause?

As will be evident from the above, whichever options are chosen, are going to prove contentious from a supplier's perspective, as they are introducing additional risk for the supplier. This does not necessarily mean that they should not be considered, because if it is reasonable in the situation to have such remedies, and both parties can understand the logic behind them, then the supplier may be able to protect itself to some extent by:

- Pricing in the additional risk into the contract;
- Putting in place a 'buffer' in the timelines to protect itself;
- Ensuring that appropriate project management is used;
- Possibly negotiating a 'bonus' payment for the supplier if performance is achieved ahead of schedule;
- Possibly imposing liquidated damages on the customer for the customer's failure to comply with timescales which have a cost impact for the supplier, where such costs are not covered by any man-day rates which would be chargeable in the event of such delay;
- Stating that where the express sub-cap is exhausted, that either party can terminate the contract for convenience rather than cause (depending upon the nature of the IT project will determine whether this is a viable option for the customer, because clearly where it leaves the customer in the 'lurch,' it will not be, however, where the customer is able to migrate the project to another supplier relatively easily (especially if it may wish to do so at that stage in view of it losing confidence in the supplier's ability to perform the contract) it might be a more feasible option to include this in the contract;
- Making the delineation between the supplier's responsibility (which triggers the liquidated damages) and the customer's responsibility (which if it affects the performance timeline avoids the liquidated damages) clear.

Final Thoughts

Liquidated damages can be a useful tool from a customer's perspective in terms of focussing the attention of the supplier on important timelines. In fact, liquidated damages can be useful from a supplier's perspective as well, if they are crystallising the total amount of the supplier's liability in respect of certain delayed milestones, provided that the supplier has had the opportunity to price this risk into the contract and set the timelines appropriately.

As can be seen from the above though, the concept of liquidated damages, is one that gives rise to a number of contentious issues. Both the supplier and the customer, therefore need to work together to determine an appropriate compromise on the position. A customer must also bear in mind that the harsher the liquidated damages' regime, the more likely that a supplier will inflate the pricing and extend the project timelines, to offset the associated risk – a customer must therefore genuinely feel that the liquidated damages are going to provide a greater adherence to timelines, than that which can be achieved through appropriate project management or governance.