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**The Light in Real Life No.11** by Lin Zihao

# IT BYTES

ANSWERING YOUR COMMON IT CONTRACT LAW QUESTIONS

# WHAT IS THE DIFFERENCE BETWEEN A LIQUIDATED DAMAGES CLAUSE AND A PENALTY CLAUSE?

## WHEN DOES THIS QUESTION TEND TO ARISE?

**A customer under an IT contract may want the supplier to pay a pre-determined amount for certain types of breaches, such as a service credit where they fail to meet an agreed service level or an amount of liquidated damages if they fail to achieve an important project milestone by the due date. This may have various advantages for the customer, including by providing greater certainty and avoiding the need for the customer to substantiate the loss they have suffered, which in many circumstances may be difficult to do (and costly). However, these types of clauses are not always enforceable. Where the pre-determined amount is found to operate as a penalty, then the obligation to pay the liquidated sum may not be enforceable if challenged.**

## WHAT DOES THE LAW SAY?

The distinction between a legitimate agreement to pay a liquidated sum and an unenforceable penalty has historically been based on principles consolidated in the House of Lords decision in *Dunlop Pneumatic Tyre Co. Ltd v New Garage and Motor Co. Ltd [1915] AC 79 (‘**Dunlop**’)*. According to those principles, a contractual obligation to pay a liquidated sum upon breach of a contract will be enforceable if the sum is held to be based on a ‘a genuine pre-estimate of damage’. However, if the payment is calculated as a punitive measure to deter the other party from breaching the contract, then it will be considered a penalty and so be unenforceable (at least to that extent).

For example, suppose a contract for delivery of construction materials included the following clause:

**PUNCTUAL DELIVERY AND LIQUIDATED DAMAGES**

a. The Goods must be delivered to the Site in accordance with the Delivery Instructions on or before the Delivery Date.

b. If the Goods are not delivered by the Delivery Date, the Supplier agrees to pay the Customer $1,000 for each successive day of lateness.

If the $1,000 was a ‘genuine pre-estimate of the damage’ suffered by the customer for each day of delay (e.g. because the customer was forced to lease equipment in place of the goods that have been delayed), then, based on the principles in *Dunlop*, it is likely this clause would be enforceable. This is even the case if it turns out that the pre-estimate exceeded the actual loss suffered by the customer, such as where it turns out that the cost to the customer of leasing substitute equipment is less than $1,000 per day.

Alternately, if the clause was only inserted into the contract to ensure the supplier had an additional incentive to deliver the goods on time and the measure of $1,000 per day had no relation to the loss that the customer anticipated they would suffer due to the late delivery, then the clause may amount to a penalty. For example, if the customer knew in advance that the cost of leasing substitute equipment would be less than $1,000 per day, but wanted to specify a higher amount simply to deter late delivery, then the clause may well be unenforceable. The fact that the clause is called ‘Punctual Delivery and Liquidated Damages’ is of no relevance to how it would be treated if challenged; a penalty will still be a penalty no matter how it is described.

The principles first outlined in *Dunlop* still apply in Australia. However, the penalties doctrine has since been refined by two related High Court decisions that considered whether late payment and other bank fees were in fact penalties: *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205 (‘***Andrews***’) and *Paciocco v Australia & New Zealand Banking Group Ltd* (2016) 258 CLR 525 (‘***Paciocco***’).

In Andrews, the High Court held that the penalties doctrine also extends to provisions requiring payments (or other transfer of value, e.g. property) on the occurrence or non-occurrence of events other than breach of contract. In practice, this means that it is not possible to ‘draft around’ a clause being considered a penalty simply by not framing the relevant trigger event as a breach. Following *Andrews*, a clause which imposes a detriment to secure performance or some other stipulation in the contract can be classified as a penalty if it is challenged, even if there is no underlying breach of contract. The Court also said that if a clause is found to be a penalty, the clause can still be enforced to the extent it can be legitimately applied – the clause isn’t wholly unenforceable.

In *Paciocco*, it was argued that since there was no evidence that the fees were a ‘genuine pre-estimate of loss’, they were in fact penalties and so were unenforceable. The Court disagreed. In doing so, it said that the relevant question was whether the fees charged were extravagant, unconscionable, and ‘out of all proportion to the interests of the party which it is the purpose of the provision to protect’. This interpretation was not necessarily inconsistent with *Dunlop*. However, it was seen as loosening some of the restrictions imposed by the principles formulated by the House of Lords, particularly for more complex contracts where predicting the likely loss that would follow a breach may be very hard to do. Practically, this means that since Paciocco contracting parties have had more freedom to draft liquidated damages clauses with a reduced risk of them being held to be unenforceable as a penalty if challenged.

## WHAT ARE THE PRACTICAL IMPLICATIONS FOR YOUR CONTRACT?

If you want to require payment of pre-defined agreed amount on a breach of contract or another trigger event in your contract, you will need to carefully consider whether the amount you have in mind appropriately reflects the loss that you may reasonably expect to suffer because of the event or breach. You will want to be able to establish that it represents a ‘genuine pre-estimate’ of your loss or at least that it was not ‘out of all proportion’ to the interests you are trying to protect.

Having said that, a clause is not unenforceable as a penalty only because in the circumstances the agreed amount is higher than the actual loss that is suffered because of the trigger. You simply need to be able to show that the agreed amount represents a genuine effort to estimate in advance the cost of the event or breach when considered at the time the contract was entered into. If your genuine estimate overshoots the mark, that will not of itself invalidate the clause.

If there are specific additional costs that you anticipate incurring if a breach or other trigger event occurs, then you should take those into account and ideally ensure that the liquidated damages you specify in the contract is based on those costs. However, that will not always be possible. In those cases, you should aim to ensure that any liquidated damages are set at a defensible amount so that you can still argue the predominant aim is to compensate for loss that you may suffer, rather than to punish the other party for a breach. In this regard, beware of what you include in unprivileged correspondence that may betray other underlying motives and may be discoverable by the other party in the event of a dispute.

Finally, it is also common to include contract terms to the effect that the parties each acknowledge that the liquidated damages in the contract constitute a genuine pre-estimate of the loss that is likely to occur due to the relevant breach. The inclusion of such a clause will make it harder for the other party to argue that, contrary to what they agreed in the contract, they no longer believe that the amounts specific represented a genuine pre-estimate.

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We would like to acknowledge the contribution of Stuart Neil to this article.

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