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BNA Insights

Do I Really Have To Pay The Penalty In My Contract?

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Contractual damages clauses are commonly used in contracts in many industries and many different circumstances. Asset managers and other financial services companies often use these clauses in employment contracts to help ensure the loyalty of key employees and to discourage them from leaving. Companies in the technology industry, real estate and other fields also use them to protect trade secrets and ensure projects are completed on time.

But whether in financial services or another industry, each of these uses can present the same crucial question to employers and businesspeople alike: When push comes to shove, can the contractually agreed upon damages clause be enforced? The answer to that basic question turns on whether damages could reasonably be calculated and the reasonableness of the agreed-upon damages amount.

A recent decision by New York's Appellate Division, resolving a high-stakes business dispute between two financial services companies, offers insight into how New York law addresses and answers those critical questions, and whether a contractual damages provision is enforceable or constitutes an impermissible penalty. It provides a useful framework for evaluating contractual damages clauses—both at the time that the parties are negotiating their terms and when the courts are called upon to consider their enforceability.[1]

The Underlying Dispute

In *Tullett Prebon Financial Services Inc. v. BGC Financial, LP*, rival interdealer brokers had a contract that restricted the distribution of each company's proprietary data and precluded competitive use by the other side for any reason (including any competitive use by the other side's brokers). The contract called for damages payments of $4,500 per day for each broker receiving the other side's data, but the parties subsequently agreed to reduce this sum to $500 per broker, per day.[2]

Pursuant to that contract, three BGC affiliates sued a Tullett affiliate for misappropriating financial data that BGC supplied to Tullett under a contract to produce a joint product called SwapMarker 100, which is widely used to price certain derivatives.[3]

The parties submitted to arbitration, during which Tullett admitted that certain brokers had received the ability to access BGC's U.S. Treasury pricing data in breach of the contract.[4]

However, Tullett also submitted evidence that BGC had licensed the same data at issue to Tullett and its predecessors for many years at prices equivalent to $10 to $15.50 per broker, per day, and charged equivalent prices to other customers and competitors.[5] In other words, the evidence showed BGC had licensed the same data for a small fraction of the $500 per broker, per day damages provision that BGC was seeking to enforce in the arbitration.

The central issue at the arbitration was whether the $500 per broker, per day figure was enforceable.

Enforceable or Penalty?

In New York, parties generally are free to set the terms of their own contracts and may agree on the damages for breach in certain circumstances. Specifically, parties are

[1] *Tullett Prebon Fin. Servs. Inc., et al. v. BGC Fin., L.P., et al.*, 111 A.D.3d 480 (N.Y. App. Div. 2013).

[2] *Id.* at 480.

[3] *Id.* at 480–81.

[4] *Tullett Prebon Fin. Servs. Inc.*, Index No. 652157/2010, Order dated Nov. 20, 2012, at 3.

[5] *Tullett Prebon Fin. Servs. Inc.*, Index No. 652157/2010, Order dated Nov. 20, 2012, at 5 n.2.

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free to agree in advance on damages where they are difficult or impossible to calculate and where the amount agreed upon bears a reasonable relationship to the probable loss.[6] Where both conditions are met, courts typically enforce contractual damages as liquidated damages. Where the damages are readily calculable or where the agreed upon amount is grossly disproportionate to the probable loss, however, the damages clause is considered a penalty.[7]

Courts consider whether the parties are sophisticated, whether they were represented by counsel and whether the clause was the result of arms-length bargaining.[8] These factors can tip the balance in close cases, but will not save a penalty that is otherwise vastly disproportionate to the probable damages viewed from the time of contracting from being declared unenforceable.[9]

Under New York law (and the law of many other states), penalties are unenforceable on public policy grounds—even if voluntarily agreed upon by sophisticated parties in arm's length negotiations—because contractual forfeitures or penalties improperly compel a party's performance through ''fear of economic devastation'' and grant the counterparty ''a windfall well above the actual harm sustained.''[10]

Tullett Prevails

Tullett argued that the $500 per broker, per day damages clause was plainly a penalty because Tullett would be required to pay 32 to 50 times the amount BGC charged to license the identical data. Tullett also relied on testimony from an expert in the U.S. Treasuries market, Professor Bruce Mizrach of Rutgers University, who explained that the $500 per day figure was far in excess of the market value of the data and that access to BGC's treasury data would not have provided a competitive advantage to Tullett's brokers compared to information available from other sources. Tullett also submitted evidence that BGC remained willing to license the data at issue to Tullett for between $17 and $20 per broker per day.[11]

In contrast, BGC emphasized the plain language of the contact, its right to control the distribution of its own data, and the fact that the contract was negotiated between knowledgeable competitors with experienced counsel and that the parties had recently amended the damages amount to reduce the amount of the damages clause by more than 80 percent. BGC also emphasized that because the damages amount was a per day, per broker amount, it was inherently proportional to the duration and scope of any breach. BGC relied on an experienced economist as well, who opined that the contractual damages amount was economically appropriate.

The arbitrator concluded that the clause was a penalty and therefore unenforceable, finding that the $500 per day figure was far in excess of the market value of the data in question.[12] He credited testimony that the $500 per day figure was not set based on any assessment of the probable harm resulting from a breach, but was instead plucked ''out of thin air.'' The arbitrator also relied on language in the contract that stated that the per day figure would ''not constitute liquidated damages.''[13]

He reasoned that because the clause was not a liquidated damages provision, nor a compensatory damages one, it could only be a penalty and therefore was unenforceable. Using the prevailing market prices, he awarded damages totaling $789,000—less than 0.5 percent of the amount claimed. The arbitrator also declined to award attorneys' fees, concluding that BGC was not the prevailing party.[14]

Tullett moved to confirm the award and BGC cross-moved to vacate it. The New York Supreme Court granted Tullett's motion, finding that the arbitrator correctly applied New York law concerning the enforceability of contractual damages clauses.[15] The court also held that any alleged error that the arbitrator committed in allocating the burden of proof to BGC was ''not a cognizable basis to vacate an [arbitration] award,'' relying on *Haynes v. N.Y.C Department of Homeless Services*.[16] Finally, the court concluded that the arbitrator acted within his discretion in determining that BGC was not the prevailing party.[17]

On appeal, the First Department found some merit in BGC's argument that the arbitrator had erred in requiring it to bear the burden of proof, but held that vacatur was not required because of the overwhelming economic evidence adduced at trial demonstrating that the $500 per day sum was a penalty, rendered ''inescapable'' the conclusion that the clause was not enforceable.[18] The First Department also found that there was no error in the arbitrator's decision that BGC was not the prevailing party.[19]

Small Proportions

Although contractual damages provisions are common features of many contracts, including employment contracts and other agreements in the financial services and technology industries, and parties are free to use them to create a disincentive for breach, it is important that such provisions only be utilized where appropriate. Setting the contractual damages provision so high as to run the risk that a court would find it an unenforceable penalty may undermine the deterrent value of such provisions.

Therefore, in an area where court judgments are fact specific, what guidance can be given to parties in negotiating and crafting contractual damages provisions?[20] At least as between sophisticated entities, courts often enforce contractual damages provisions of between one and three times the anticipated losses.[21] Where

[6] *E.g.*, *JMD Holding Corp. v. Congress Fin. Corp.*, 4 N.Y.3d 373, 380 (2005).

[7] *Truck Rent-A-Ctr., Inc. v. Puritan Farms 2nd, Inc.*, 41 N.Y.2d 420, 425 (1977).

[8] *E.g.*, *JMD Holding Corp.*, 4 N.Y.3d at 382–83.

[9] *See, e.g.*, *In re TWA, Inc.*, 145 F.3d 124, 135 (3d Cir. 1998) (applying New York law).

[10] *Id.* at 424.

[11] *Tullett Prebon Fin. Servs. Inc.*, 111 A.D.3d 480, 481 (N.Y. App. Div. 2013).

[12] *Tullett Prebon Fin. Servs. Inc.*, 111 A.D.3d at 481.

[13] *Id.* at 480.

[14] *Id.* at 481.

[15] *Tullett Prebon Financial Servs. Inc., et al. v. BGC Financial, L.P., et al.*, Index No. 652157/2010, Order dated November 20, 2012 at 5.

[16] *Id.* (citing *Haynes*, 27 A.D. 3d 330, 332 (N.Y. App. Div. 2006)).

[17] See *id.*

[18] *Tullett Prebon Fin. Servs. Inc.*, 111 A.D. 3d at 481.

[19] *Id.* at 482–83.

[20] As the reader doubtless appreciates, each situation is different; prior results do not guarantee a similar outcome. Those seeking legal advice should consult with an experienced attorney about the particulars of their situation.

[21] *See, e.g.*, *Rattigan v. Commodore Int'l Ltd.*, 739 F. Supp. 167, 192 (S.D.N.Y. 1990) (enforcing damages clause in employment agreement providing for accelerated salary payment upon involuntary termination of 125 percent of salary); *Withers Bergman LP v. Solus Alt. Asset*

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parties have unequal bargaining power, such as in many residential leases, consumer contracts or contracts of adhesion, courts may be more willing to set aside contractual damages provisions as unenforceable penalties.[22]

Although parties occasionally may perceive that the ''added'' deterrence from a larger penalty is desirable, regardless of its enforceability, one to three times the probable harm is ordinarily more than adequate to encourage counterparties to comply with the contract. Moreover, the reported decisions under New York law reveal five times the probable loss as the largest multiple that a court has ever enforced.[23]

Scalable Amounts, Look Ahead

In drafting an enforceable liquidated damages clause, amounts that are scalable with the duration and extent of the breach are more likely to be enforced than fixed amounts, which may appear disproportionate to the harm caused by technical breaches. For example, courts are more likely to enforce clauses that set damages for a departing employee based on the time remaining under the contract and the employee's historical revenues.[24] Drafters should take care in shaping these provisions. For instance, employers may wish to consider using the highest months over some period in setting a damages amount to avoid an inadequate remedy where the employee-generated revenues may grow substantially toward the end of an employment period.

More generally, parties entering into agreements containing contractual damages clauses should carefully consider the explanations they may need to offer later (to dispute resolution bodies) in articulating what damages were anticipated at the time of contracting, how those damages were uncertain or difficult to compute, and why the contractual sum is not vastly disproportionate to such damages.

Proportionality, Careful Language

Another point of caution involves using the same liquidated damages clause where there are multiple contract provisions that can be breached, but that would result in different probable harms. There is authority in New York for the proposition that contractual damages clauses are unenforceable if disproportionate to the harm of one such breach or if the anticipated harm from the breach of one provision is readily calculable.[25]

Individuals seeking to draft enforceable liquidated damages clauses are well advised to consider language providing that the parties agree that actual damages are difficult to estimate and that the amount selected is a reasonable estimate of the probable loss among other provisions. Those seeking enforceable damages provisions also should avoid language that refers to the amount as a ''penalty'' or that provides that the damages are not ''liquidated damages.''

Likewise, parties should refrain from including provisions that seek to retain the right to obtain actual damages in excess of the contractual amounts because an enforceable liquidated damages clause generally precludes the recovery of additional damages; therefore, the suggestion that damages can be quantified (by retaining the right to seek them) undercuts the argument that the contractual damages provision was necessary because of the difficulty or impossibility of quantifying expected damages.[26]

Parties also should seek to document their estimates of potential harm and retain them; they may be needed when courts look to enforce any agreed-upon liquidated damages sums.

Conclusion

Contracting for liquidated damages clauses that New York courts will enforce requires thoughtful drafting. Likewise, numerous pitfalls confront businesses that must litigate the enforceability of liquidated damages clauses, requiring care and creativity. Large sums can turn on whether the courts actually will enforce the negotiated clause.

Hedge funds, investment banks, asset managers and other businesses seeking to enforce—or invalidate—contractual damages provisions should heed the teachings of the Appellate Division's latest lesson and proceed carefully.

Mgmt. L.P., 35 Misc. 3d 138(A) (Table) (N.Y. App. Div. 2012) (holding that commercial lease clause for triple rent for failure to vacate was not an unenforceable penalty).

[22] *See, e.g.*, *Gellis v. Marshak*, 17 Misc. 3d 128(A) (Table) (N.Y. App. Div. 2007) (residential lease clause escalating rent 300% for failure to vacate was unenforceable penalty).

[23] *Addressing Sys. and Prods., Inc. v. Friedman*, 874 N.Y.S.2d 430, 431–32 (App. Div. 2009).

[24] *See, e.g.*, *GFI Brokers, LLC v. Santana*, No. 06 Civ. 3988, 2009 BL 171765, at *4–5 (S.D.N.Y. Aug. 13, 2009) (enforcing clause in broker's contract computing damages based on average monthly revenues in 12 months preceding termination times number of remaining months under contract and post-termination non-compete period).

[25] *E.g.*, *Vernitron Corp. v. CF 48 Assocs.*,104 A.D.2d 409, 410 (N.Y. App. Div. 1984).

[26] *E.g.*, *Int'l Fid. Ins. Co. v. Cnty. of Chautauqua*, 245 A.D.2d 1056, 1057 (N.Y. App. Div. 1997).