100% Cancellation Damages—Legal Enforcement Challenges

It is very common in the meeting and event industry to see suppliers—hotels, convention centers, other venues—including a requirement in their contract’s cancellation clause that requires the payment of 100% of the value of the event for a cancellation that occurs shortly before the scheduled event date. While it may seem logical, because the supplier assumes in a “last minute” cancellation that it will be unable to replace the revenue the event would have generated, in most cases such a clause is unenforceable under the law.

Basics of Contract Damages

Many suppliers and meeting planners talk about cancellation or attrition “penalties,” but that is a legally incorrect term. A “penalty” is a punishment imposed for doing something wrong, like breaking the law. When a party does not perform a contract as agreed, the party has not broken the law, it has just breached a commitment. The breaching party is not punished for the breach, instead the breaching party is “liable” or must pay “damages” to compensate the non-breaching party.

The purpose of damages for a breach of contract is to “put the non-breaching party in the position it would have been in if the breach had not occurred.” This is a very critical concept to understand in order to understand why 100% damages are often unenforceable, as will be explained below. Damages are not supposed to punish the breaching party, nor are they supposed to overcompensate the injured party.

Technically, a “penalty” in a contract is unenforceable under the law. If parties to a contract use the incorrect term of “penalty” it does not necessarily mean that the clause will not be enforced, but if a court or arbitrator finds that the clause was intended to punish the breaching party, rather than fairly compensate the non-breaching party, the clause will be invalidated.

Basics of Liquidated Damage Clauses

Generally, whenever a contract is breached the other party is legally entitled to collect monetary losses suffered as a result. No clause is needed; the law automatically will award damages. However, sometimes the parties agree in their contract on the amount that will be paid in the event of a breach. The law allows contracting parties to do that when it is clear that an injury will occur in the event of a breach, but it is difficult to determine the amount. Instead of requiring the injured party to prove how much it lost, the
parties simply agree in their contract on the amount that will be paid, which is known as "liquidated damages."

In event contracts the parties typically agree on liquidated damages that will be paid for the group’s cancellation or lack of full performance of the contract (often referred to in the industry as "attrition"). Many courts and arbitrators have ruled that liquidated damages are appropriate in event contracts because it is very difficult to determine actual loss.

The key to the legal enforceability of a liquidated damage clause is that it must be a reasonable estimate of the loss that the injured party would suffer as a result of the breach. That is why cancellation clauses usually have a sliding scale of damages that increase as the date of cancellation gets closer to the date of the scheduled event, on the assumption is that the closer in time to the event date that the cancellation occurs, the less likely it will be that the hotel can resell the cancelled accommodations, thus the hotel will suffer a greater loss.

It is important to understand that the hotel cannot determine the profit it makes on an individual room or group of rooms, which is it why it is so difficult to prove its actual loss. Clearly, a hotel does not make the same profit on one room that it sells for $250 as it does on another room that it sells for $189. However, a hotel does know its overall average profits and must consider the overall profit potential of an event when setting the amount of damages. The damages agreed upon do not have to be a perfect estimate. If it turns out that the actual loss is higher or lower the injured party is still entitled to the amount agreed upon, so long as the amount was reasonable at the time the contract was signed. On the other hand, if the amount of damages agreed upon was unreasonably high or low at the time the contract was signed, a court can refuse to enforce the clause and instead will require the hotel to prove its actual loss, a difficult, time consuming and expensive process.

Why 100% Damages Are a Potential Problem

While a hotel (or other venue) cannot know the profit it makes on a particular event, it does know its average overall profits. Based on that, it can estimate the overall profit it will make if an event is held. Consider this example:
<table>
<thead>
<tr>
<th>Service</th>
<th>Revenue</th>
<th>Est. Profit %</th>
<th>Estimated Profit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rooms</td>
<td>$75,000.00</td>
<td>80%</td>
<td>$60,000.00</td>
</tr>
<tr>
<td>Food and Beverage</td>
<td>$30,000.00</td>
<td>40%</td>
<td>$12,000.00</td>
</tr>
<tr>
<td>Meeting Room Rental</td>
<td>$10,000.00</td>
<td>95%</td>
<td>$9,500.00</td>
</tr>
<tr>
<td>Other</td>
<td>$20,000.00</td>
<td>75%</td>
<td>$15,000.00</td>
</tr>
<tr>
<td><strong>Total Revenue</strong></td>
<td><strong>$135,000.00</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total Overall Estimated Profit</strong></td>
<td><strong>71%</strong></td>
<td><strong>$96,500.00</strong></td>
<td></td>
</tr>
</tbody>
</table>

* Note that estimated profit % varies by season, day of week, concessions given, etc.

In the example above, the event represented revenues of $135,000, but if the event had been held, after the hotel paid all of its expenses, its estimated overall profit would have been $96,500, or about 71% of the revenue generated.

If the hotel’s cancellation clause required the customer to pay 100% of anticipated revenue, the group would pay $135,000. The hotel would put virtually all of that money in the bank (the hotel would have incurred some expense in selling the event, etc., but usually not significant amounts). Thus if the hotel collected 100% damages, it would end up putting more money in the bank than it would have if the event had actually been held.

100% damages **usually** results in the hotel being better off receiving cancellation damages than it would have been if the event had actually been held. That is improper under the law and would be considered an unenforceable penalty.

While liquidated damages do not have to be based on “profit” or use the word “profit” in the clause under the law, the maximum amount agreed upon should not exceed a reasonable estimate of what the venue would have made if the event had been held as contracted (the estimated overall profit). When setting that amount, the parties should consider not just the overall profit potential, but also what revenues and profits the hotel might be able to recover by reselling the cancelled inventory. That is why the “sliding scale” is typically used in cancellation damages.

Keep in mind that the example above is very basic. The revenues listed above do not include many potential revenue sources that a hotel might lose if an event were cancelled, like bar and restaurant revenue, room service, business center, fitness center, spa, etc., each of which has its own estimated profit. The list could be extensive and all revenue sources should be considered when negotiating a cancellation provision.
Is a 100% Damage Provision Ever Valid?

Whenever you see a “100%” in a cancellation clause, it is a red flag that requires close examination. Your first question should be, “100% of what?” 100% of total revenue is probably rarely going to be enforceable. However, 100% of a portion of revenues might be reasonable.

For example, if the hotel required damages of 100% of Room Revenue for a late cancellation in the example above, it would mean that the customer would owe $75,000 in room revenue as damages. $75,000 is well below the total overall estimated profit of $96,500, so it would not be exceeding the overall value of the event to the hotel and would be enforceable.

Also, do not confuse the cancellation damage percentage owed with the attrition or performance commitment. Hotels could legally, if they wanted, require a group to fill 100% of its reserved block. While it is common in the industry for hotels to provide a concession allowing the customer to leave a portion of its block unfilled without payment (often called an “attrition allowance”), a hotel has every right if it chooses to require the customer to fill 100% of its block and require payment of damages if it does not do so. While some might argue that it is unfair to require the group to pay 100% of the room rate for unused rooms, the damages owed are intended not just to cover the lost estimated room profit, but also the additional ancillary losses from having unused rooms and the additional costs incurred by the hotel in attempting to resell the unfilled rooms.

Why Do Hotels Include 100% Damages If It is Not Legally Enforceable?

Venue salespeople are not always legally trained, just like their meeting planner counterparts. It may be that the people negotiating the contract simply do not know that 100% damages can be problematic.

Another reason that 100% damages is often used is that hotels find that when customers do cancel, they do not voluntarily comply with the cancellation clause that was negotiated and agreed upon. Hoteliers often say that customers treat the cancellation clause in the signed contract as the beginning of the negotiation, not as the amount already settled. It is not uncommon to hear, “If I agree on a fair amount of 65%, when the customer cancels they always want to negotiate down from there and I end up not getting fully paid. If my clause is at 100%, then the customer negotiates down to the reasonable amount I should have gotten all along.”

While suppliers and customers are not lawyers, if they understand the legal requirements of damage clauses, negotiate them fairly and reasonably, and then adhere to them as written when a cancellation occurs, the problem of the 100% cancellation clause can be solved.