

Liquidated Damages Contract Risk Management



Why Liquidated Damages?

Money may not be the answer to all programs which run late, as delivery on time may be the only priority. All clients want projects to specification and financial remedy is not as satisfying as a perfect project. When things do go wrong or when something is not operating properly, or is delayed, a solution is what clients want.

In spite of this, general damages (or unliquidated damages) are one of the most important remedies for a breach of contract, but requires that firstly, the non-defaulting party proves that it has incurred actual loss as a result of the breach and secondly that the loss must not be too remote **Hadley v Baxendale [1854]**.

A liquidated damages clause (LAD) avoids these two legal requirements. The Employer only needs to prove that a breach has occurred and the calculation based on an estimate of the costs resulting from the non performance.

In practice, making that calculation may not be so easy. Most standard forms have a

liquidated damages clause inserted in the contract. Liquidated damage is then the sole remedy, stating an amount or rate calculated in advance, usually payable by the contractor, for a delay to a project or performance failure. It is usually expressed in the contract as a fixed sum, daily or weekly rate.

However for a liquidated damage clause to successfully apply it must be a 'genuine pre-estimate' of the employer's anticipated loss in the event of delay to the project. The onus is therefore on the employer to predict and genuinely estimate what the loss would be to his business, in the event that the contractor fails to complete the Works or a Section of the Works by the completion date.

If things go wrong the contract mechanism provides a formula to assess the loss to the client without the bother of adding up its actual losses. This is much neater, but of course subject to challenge if not done properly. However, a client cannot rely on LADs where the client hinders or prevents the contractors progress **Peek Construction (Liverpool) Ltd v McKinney Foundations Lrd CA [1970]**.

Something for Nothing (Well Almost)

By calculating a rate for compensation in advance and including it in the contract:

- Commercial tension is created for performance and/or timely delivery
- The contracting parties have the certainty of knowing in advance what the financial cost of delay is and how that risk is allocated



- The non-defaulting party benefits from making a recovery of damages without the difficulty and expense of proving actual loss (usually to the client's benefit)
- Legal costs are reduced with recovery of compensation made under the contract
- Contractual obligations are reinforced to deter breach
- The contractor can appreciate the financial implications of completing, plan to complete on time or price the risk of delay (at least in theory).

Be Informed If You Want Something

Generally the courts will look to uphold a liquidated damages clause in construction contracts provided it can be demonstrated that the figure / rate is based on a sensible criteria. In particular a court will be reluctant to interfere with a liquidated damages clause negotiated by commercial parties.

In case of a challenge and from a practical perspective when drafting liquidated damages clauses it would be prudent to retain evidence of how the pre-determined sum was calculated and evidence demonstrating that the figure was negotiated. Secondly parties should also consider any limit of liability and whether the total amount payable should be capped and at what level.

You Get Nothing If It's Not That Something

As the LADs clause is supported by the courts it could be tempting to "over egg" the calculation to get that little extra back for the client. Unfortunately, a liquidated damages clause will not be enforceable if it is

considered to be an unreasonable estimate of the probable loss and therefore constitutes a 'penalty', a principle laid down by the courts in **Dunlop Pneumatic Tyre Co Ltd v New Garage Co Ltd [1915] AC 79.(HL)**. In this case the court decided that a liquidated damages clause would be considered a penalty and unenforceable where the sum to be paid by the defendant was 'extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have followed from the breach'.

However, the onus of proving that the liquidated damages clause amounts to a penalty falls upon the challenging party **Jeancham Ltd v Barnet Football Club Ltd [2003] EWA Civ 58**.

Be Genuine If You Want That Something

There are particular issues to be aware of in relation to projects where LADs apply to sectional completion or partial possession of the site is required.

In such projects the liquidated damages provision should stipulate how the monies payable in the event of late completion or partial completion are apportioned between the different stages of work or by reducing that sum by reference to the part of which possession has been taken. Failure to do so can prove fatal to the employer's claim for liquidated damages.

For example in **Bramall & Ogden v Sheffield City Council [1983]** a provision for liquidated damages at a weekly rate in relation to each uncompleted house was held to be inconsistent with a reduction of liquidated damage upon partial possession.



Nothing Really Means Nothing

You will lose the right to LADs if the clause is left blank or states "nil". Most of the standard forms of contract provide for liquidated damages for the contractor's breach of his obligations.

However, only the 7th Edition of the ICE addresses the consequences of an entry of "nil" or the rate left blank.

ICE 7th at sub-clause 47(1) and Clause 47(2) provides for liquidated damages to be stated for the whole of the Works and Section(s) of the Works respectively. These clauses require a sum to be stated in the Appendix to the Form of Tender.

Sub-clause 47(4)(b) states that if no sum is stated in the Appendix or a sum of "nil" is inserted then "to that extent damages are not payable."

It is suggested on an interpretation of the Contract as a whole that this does not mean that the LAD provisions do not apply but that the level of LADs is nil. Some may say this amounts to the same thing.



Other standard forms follow the view taken by the courts in **Temloc Ltd v Errill Properties Ltd [1987] 39BLR34 CA** where under the liquidated damage clause the amount was stated to be "nil". The court held that on the proper construction of the contract the parties had come to an exhaustive agreement as to the damages payable by the contractor in the event of failure to complete the work on time. The agreement was that no damages of any

Something For Nothing

Conversely, if the contract is left blank and contractor fails to complete on time, the Employer may pursue a claim for damages under the normal operation of the law. However, the Employer would have missed a valuable opportunity to quantifying his losses from the outset and would undoubtedly incur additional expense in pursuing his claim.

Where the parties delete the liquidated damages clause and the contractor fails to complete the project on time, the Employer may pursue a claim for damages under the normal operation of the law. Only clear express words may rebut this presumption **Gilbert-Ash (Northern) Ltd v Modern Engineering (Bristol) Ltd [1974] AC689 HL**.

It is possible however for the parties during their negotiations to delete the liquidated clause and also the right to any damages for late completion. This possibility was the issue in **Chattan Developments Limited v Reigill Civil Engineering Contractors Limited [2007] EWHC 305 (TCC)**.



Useful Tips

1. The liquidated damages amount should be a 'genuine pre-estimate' of the employers anticipated loss. A copy of the calculation sheet should be kept on file as a contemporary note of the estimate.
2. Document any negotiations which led to the 'agreed' amount.
3. Document the calculations in the contract or in correspondence.
4. Ensure that the amount does not amount to a penalty by reference to tests in Dunlop.
5. If sectional completion is required – apportion liquidated damages between the sections.
6. Make provision in the contract for a reduction of liquidated damages in the event of partial possession.
7. Never insert "nil" as this will result in no entitlement to damages as a result of delay.
8. And always take advice; if in doubt contact CS "FREE" for Advice

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