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Liquidated damages: a round up[1]

The recent TCC case of *Eco World – Ballymore Embassy Gardens Company Limited v Dobler UK Limited*[2] and the Supreme Court case of *Triple Point Technology, Inc v PTT Public Company Ltd*[3] provide much food for thought for those in the construction industry negotiating and interpreting liquidated damages provisions.

In this Insight, we go "*back to basics*" on liquidated damages provisions, ask what lessons can be drawn from this recent case law, and highlight the points that those negotiating liquidated damages provisions may want to consider going forwards in light of these cases.

So, what are liquidated damages?

As explained by Lord Leggatt in *Triple Point*:

"A liquidated damages clause is a clause in a contract which stipulates what amount of money will be payable as damages for loss caused by a breach of contract irrespective of what loss may actually be suffered if a breach of the relevant kind (typically, delay in performance of the contract) occurs. Liquidated damages clauses are a standard feature of major construction and engineering contracts and commonly provide for damages to be payable at a specified rate for each week or day of delay in the completion of work by the contractor after the contractual completion date has passed."
[Emphasis added]

Liquidated damages are most commonly levied in construction projects in relation to delays to the completion of the works. However, liquidated damages are also levied in projects such as process engineering and power projects where, for example, performance specifications are not met.[4]

The benefits of a liquidated damages provision for both parties to construction contracts are well known and acknowledged by the Courts, including in the Supreme Court decision of *Triple Point*. They include:

1. Avoiding the need for an employer to quantify its losses which may be difficult, time consuming and costly to do;[5]
2. Allowing both parties to properly manage the financial consequences of the risk. Liquidated damages achieve this by limiting a contractor's exposure to liability of an otherwise unknown and open-ended risk, whilst also allowing an employer to ascertain in advance what they would receive in such circumstances.[6]

As such, these clauses can provide reassurance to contractor and employer alike that they both know the consequences of delaying the project or not hitting a particular performance specification.

Liquidated damages or a penalty?

If liquidated damages provisions are held to be a penalty, then, *prima facie*, they are void and unenforceable. However, the test as to what constitutes as a penalty has moved away from the famous *Dunlop Tyre*[7] case in recent years. In particular, the Supreme Court case of *Makdessi*[8] placed more emphasis on the freedom of commercial parties in deciding what to sign up to in their contracts than the traditional Dunlop tests.

The position as outlined in Cavendish Square Holding BV v Makdessi

The 2015 Supreme Court case of *Cavendish Square Holding BV v Makdessi*[9] provides a comprehensive review of the law governing the circumstances in which a liquidated damages provision will be struck down for being a penalty. In providing that review, Lords Neuberger and Sumption drew attention to what they saw as an "*artificial categorisation*" between penalties and genuine pre-estimates of loss which had grown out of the *Dunlop Tyre* case from the early twentieth century.

Instead, they emphasised that: *"The true test is whether the impugned provision is a secondary obligation which imposes a detriment on the contract-breaker out of all proportion to any legitimate interest of the innocent party in the enforcement of the primary obligation ..."*[10]
[Emphasis added]

The Supreme Court did note, however, that Lord Dunedin's tests from the *Dunlop Tyre* case would *"normally be perfectly adequate to determine its* [a liquidated damages clause] *validity"*. For those that need a refresher, those tests are as follows:

"1. Though the parties to a contract who use the words "penalty" or "liquidated damages" may prima facie be supposed to mean what they say, yet the expression used is not conclusive. The Court must find out whether the payment stipulated is in truth a penalty or liquidated damages. This doctrine may be said to be found passim in nearly every case;

2. *The essence of a penalty is a payment of money stipulated as in terrorem of the offending party; the essence of liquidated damages is a genuine covenanted pre-estimate of damage;*

3. *The question whether a sum stipulated is penalty or liquidated damages is a question of construction to be decided upon the terms and inherent circumstances of each particular contract, judged of as at the time of the making of the contract, not as at the time of the breach; and*

4. *To assist this task of construction various tests have been suggested, which if applicable to the case under consideration, may prove helpful, or even conclusive."* [Emphasis added]

In other words, if you observe the *Dunlop Tyre* guidance when drafting your liquidated damages provisions, you are unlikely to ever have to consider the *Makdessi* test. If, however, there is still room for doubt after the Dunlop Tyre tests have been applied, the Supreme Court emphasised that there should be a "*strong initial presumption*" on upholding the bargain of the parties "*in a negotiated contract between properly advised parties of comparable bargaining power.*"[11] The Courts are not, therefore, just concerned with whether the rate of liquidated damages is a genuine pre-estimate of loss. They will also consider the other legitimate interests of the innocent party in ensuring timely performance of the contract.

So what does Eco World v Dobler add to the mix?

Eco World – Ballymore Embassy Gardens Company Limited v Dobler UK Limited[12] provides a useful example of how the *Makdessi* guidance plays out in practice. It also provides a timely reminder for contractors and employers alike to actively consider (rather than assume) what impact partial possession or sectional completion will have on any liquidated damages provisions contained within their contracts.

The facts

The brief facts of *Eco World* were that the employer (**EWB**) engaged Dobler UK ("**Dobler**") as Trade Contractor under an amended JCT 2011 Construction Management Trade Contract (the "**Contract**") for the design, supply and installation of façade and glazing works. Whilst the building contained Blocks A, B and C, the Contract itself did not distinguish between sections and the Contract did not contain any provision for sectional completion of the works. The date for completion changed from 21 August 2017 to 30 April 2018 by Deed of Variation.

EWB took over Blocks B and C on 15 June 2018 (i.e., it took partial possession) with practical completion of the remainder of the works being certified on 20 December 2018. EWB levied liquidated damages from 30 April 2018 to 20 December 2018. In doing so, it applied the full rate (being the only rate provided for within the Contract) despite having taken possession of some of the works prior to practical completion.

One of the questions for Mrs Justice O'Farrell was whether the liquidated damages provision was void because it was a penalty in circumstances where partial possession had been taken but there was no mechanism for reducing the amount levied as a result of that.

The analysis

The Judge analysed the *Makdessi* test as to what constitutes a penalty as well as acknowledging the commercial purpose to both parties of liquidated damages provisions (quoting from *Triple Point* in the process). She then emphasised that the starting point was to construe the relevant provisions noting that:

"It is now well-established that, when interpreting a written contract, the court is concerned to ascertain the intention of the parties by reference to what a reasonable person, having all the background knowledge which would have been available to the parties, would have understood them to be using the language in the contract. It does so by focusing on the meaning of the relevant words in their documentary, factual and commercial context. That meaning has to be assessed in the light of (i) the natural and ordinary meaning of the clause, (ii) any other relevant provisions of the contract, (iii) the overall purpose of the clause and the contract, (iv) the facts and circumstances known or assumed by the parties at the time that the document was executed, and (v) commercial common sense, but (vi) disregarding subjective evidence of any party's intentions."[13]
[Emphasis added]

After consideration of case law, the Judge concluded that the natural and ordinary meaning of the "*works*" was that Dobler was obliged to complete all the works (i.e., Blocks A, B and C) by the completion date. The words were "*reasonably clear and certain*".[14] Further, the "*liquidated damages provision in this case is not unconscionable or extravagant.*"[15] Accordingly, the liquidated damages were not a penalty, and the provisions should be upheld.

In reaching her conclusion, Mrs Justice O'Farrell noted: (1) both parties had external legal advisers; (2) the advantages liquidated damages provisions offer to parties as observed in *Triple Point*; (3) the legitimate interest EWB had in enforcing the completion of all of the works by a certain date; and (4) the difficulties in calculating reductions in liquidated damages for partial possession (given this was a façade and glazing works contract). Finally, she noted that there was no suggestion that the liquidated damages were unreasonable or disproportionate to the likely losses.

She also held, on an *obiter* basis, that even if the liquidated damages provision itself had been held to be void (which it was not), the Court would have upheld the overall cap on delay damages contained within the same provision.[16] Again, the theme of party autonomy and freedom of contract is seen clearly in her decision.

What happens to liquidated damages on termination?

The Supreme Court decision in *Triple Point* has now confirmed that, where there is a termination during a period of culpable delay, liquidated damages will accrue up to termination. However, after the termination, any damages flowing from additional delays must be claimed as general damages arising pursuant to that termination. This is essentially the orthodox position which was widely accepted by practitioners and textbooks prior to the controversial Court of Appeal decision for *Triple Point* in 2019.[17]

As eloquently stated by Lady Arden, the Court of Appeal had, in her view, thrown "*out the baby with the bathwater*"[18] in stating that all accrued rights to liquidated damages up to completion fell away on the wording of the Triple Point contract. Going forwards, then, parties do not need to expressly provide for what happens to liquidated damages on termination in their contracts. This should be taken as read. At least then the parties can still benefit from certainty as to what liquidated damages rate is applicable to any delays accrued prior to termination.

That said, it will be interesting to see if any cases emerge in the future as to how contracts, which inserted bespoke wording in relation to the consequences of termination on liquidated damages in light of the Court of Appeal's now overturned judgment, should be interpreted. For example, the NEC had suggested express wording to clarify that delay damages ended upon termination and that any further loss would form part of the general costs / damages.[19] Such wording should now be unnecessary but if bespoke wording agreed in between the Court of Appeal and Supreme Court decisions departed from the orthodox position, it could raise some interesting discussions in the years to come.

Things to think about going forwards

In summary then, the *Makdessi* test, as applied in *Eco World*, suggests that it will be much harder to challenge liquidated damages provisions as penalties in the future. This is even more likely to be the case where the parties in question both benefitted from external legal advice and are commercial entities of equal bargaining power. There is a strong presumption that the Courts will, as a matter of policy, uphold the bargain that parties have made in setting the rate of liquidated damages. As outlined above, this is because such provisions serve a clear commercial purpose in managing and quantifying the risks they relate to.

That said, if you are the party likely to be receiving payments of liquidated damages for delay, it is always going to be sensible to ensure you have contemporaneous calculations (i.e., from the time before you entered into the contract) showing your pre-estimates of loss saved in case you need them in the future. These can then be used to justify your liquidated damages rate. As emphasised in the *Makdessi* case, if you pass the *Dunlop Tyre* tests, then you are likely to be in a very strong position in ensuring your liquidated damages provision is enforced.

Given the difficulty in successfully arguing a liquidated damages provision is penal and void, any paying party needs to take care that they fully understand the potential implications of the mechanisms they are signing up to. For developments where it is possible that partial possession or sectional completion may take place, then it is important to ensure (if you are the paying party) that there is some way of reducing the value of liquidated damages imposed in those circumstances.

Otherwise, if there are clearly drafted provisions imposing one rate of liquidated damages regardless of partial possession, it may be difficult to challenge them if the circumstances are similar to those in *Eco World*. This is the case even where, as in *Eco World*, it may seem unfair that the same liquidated damages rate applies despite partial possession taking place. Simply put, mere unfairness is not the test. The provision must "*impose a detriment on the contract-breaker out of all proportion to any legitimate interest of the innocent party.*"

The good news is that the one thing parties do not expressly need to consider following the Supreme Court *Triple Point* decision is what the consequences of termination are on their liquidated damages provisions. As Lord Leggatt stated: "*it is ordinarily to be expected that, unless the clauses clearly provides otherwise, a liquidated damages clause will apply to any period of delay in completing the work up to, but not beyond, the date of termination of the contract.*"

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Footnotes

1. By Claire King and Laura Bowler.
2. [2021] EWHC 2207 (TCC).
3. [2021] UKSC 29.
4. See Construction Law, 3rd Edition by Julian Bailey, Section 13.121, Liquidated Damages (Informa).
5. See *Triple Point,* as per Lady Arden at paragraph 35.
6. Ibid as per Lord Leggatt at paragraph 74. Also cited in *Eco World* at paragraph 53.
7. *Dunlop Pneumatic Tyre Company Ltd v New Garage & Motor Company Ltd* [1915] A.C.79 HL.
8. *Cavendish Square Holding BV v Makdessi* [2015] UKSC 67.
9. [2015] UKSC 67.
10. Ibid at para 32.
11. [2015] UKSC 67 at para 35.
12. [2021] EWHC 2207 (TCC).
13. See *Eco World* at paragraph 54.
14. See *Eco World* at paragraph 75.
15. See *Eco World* at paragraph 78.
16. See *Eco World* at paragraph 116. The relevant provision stated: "*Liquidated damages will apply....at the rate of £25,000 per week (or pro rate for part of a week) up to an aggregate maximum of 7% of the final Trade Contract Sum...*" [Emphasis added] It is worth noting that the unamended NEC3 EEC, NEC4 EEC, JCT Design and Build 2011 and JCT Design and Build 2016 do not provide for a cap. This is therefore worth considering especially if you are the paying party.
17. *Triple point Technology v PTT Public Company* [2019] EWCA Civ 230.
18. See *Triple Point* [2021] UKSC 29 at para 48.
19. See NEC4 amendments - *https://www.neccontract.com/About-NEC/News-and-Media/NEC4-October-2020-Amendments*.