Deconstructed Liquidated Damages: Review of Recent Developments (Part Two)

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Penalty-Proofing Liquidated Damages Clauses

Nicholas Higgs

Penalty-proofing LDs Clauses

"*Genuine pre-estimate of loss*" – still relevant post *Makdessi*?

- After over 100 years of the test it is part of the construction law lexicon – see Sir Rupert Jackson in *Triple Point Technology Inc v PTT Public Co Ltd* [2019] EWCA Civ 230 at [71] and Coulson LJ in *North Midland Building Ltd v Cyden Homes Ltd* [2018] EWCA Civ 1744.

- Although, the lexicon is changing:

> "*In those circumstances, the liquidated damages provision is not extravagant, exorbitant or unconscionable. It is a secondary obligation which imposes a detriment on Dobler which is proportionate to the legitimate interest of EWB in the enforcement of the primary obligation of completion of the Works in accordance with the terms of the Contract. In conclusion, the liquidated damages provision is valid and enforceable*."
>
> *Eco World – Ballymore Embassy Gardens Company Limited v Dobler UK Limited* [2021] EWHC 2207 (TCC) Mrs Justice O'Farrell DBE

Penalty-proofing LDs Clauses
Any change needed post-*Makdessi*?

- If a genuine pre-estimate of loss => very unlikely to be extravagant, exorbitant or unconscionable.

> *""Genuine" in this context does not mean "honest"; and much less, as the argument before us at one stage suggested, that the sum stipulated must be in fact an accurate statement of the loss. Rather, the expression merely underlines the requirement that the clause should be compensatory rather than deterrent.*"
>
> ***Murray v Leisureplay Plc*** [2005] EWCA Civ 963 [111] [NB pre-*Makdessi*]

- Standard measures such as: loss of rental income, delayed production, extended supervision / site establishment, etc. will normally fall well within the *Makdessi* test.

- Records, records, records: a contemporaneous document showing the calculation will be invaluable.

Penalty-proofing LDs Clauses
Wider discretion / latitude *post-Makdessi*?

- Greater assurance for public sector clients, or for projects where direct loss is difficult to quantify:
  - Secondary obligation? ☑
  - Legitimate interest to be protected? ☑
  - Proportionate? ☑
  - Not extravagant, exorbitant or unconscionable? ☑
- E.g. consider means of valuing measure of social value / return on investment / shadow tolling revenue?
- But – don't get greedy: *Blu-Sky Solutions Ltd v Be Caring Ltd* [2021] EWHC 2619 (Comm) (8x loss was disproportionate and unconscionable for cancellation).

Penalty-proofing LDs Clauses
Alternative means of obtaining performance?

- Use of KPIs?
  - Quality marks in tenders converted to monetary value equivalent to quality %.
  - KPIs could include completion milestones.
  - Contractor to earn full tender price by delivering quality objectives.
- Bonusses for early completion?
- Client training on contract mechanisms / contract teach-in?
- Prevention better than cure.

Applications to Adjust Liquidated Damages Clauses

Ruth Keating

Purpose of LDs clauses

- They usually relate to specific breaches.
- As matter of construction, they operate as an exclusive remedy in respect of that breach.
- The core theme is that liquidated damages clauses are aimed at increasing certainty for the parties and cutting through a very cost intensive exercise.

Hope in an application to adjust a LDs clause?

- Contrary to the aims of the case law in the UK.

- *Cavendish Square Holding BV v Talal El Makdessi* [2015] UKSC 67 (at [35]):

  "In a negotiated contract between properly advised parties of comparable bargaining power, the strong initial presumption must be that the parties themselves are the best judges of what is legitimate in a provision dealing with the consequences of breach."

  "Lord Woolf specifically referred to the possibility of taking into account the fact that "one of the parties to the contract is able to dominate the other as to the choice of the terms of a contract" when deciding whether a damages clause was a penalty… However, Lord Woolf was rightly at pains to point out that this did not mean that the courts could thereby adopt "some broader discretionary approach."

Hope in an application to adjust a LDs clause?

- Paragraphs 32-33:

  "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. The innocent party can have no proper interest in simply punishing the defaulter.

  …

  33. The penalty rule is an interference with freedom of contract…"the court has to be careful not to set too stringent a standard and bear in mind that what the parties have agreed should normally be upheld", not least because "[a]ny other approach will lead to undesirable uncertainty especially in commercial contracts"."

What about other jurisdictions?

- There are differences on this question between different jurisdictions – it is always important to check.

- For examples, different approaches are taken as a matter of Omani, Jordanian and UAE laws.

- See also the different approach in China. (Under Article 29 of the Interpretation of the Supreme People's Court on Issues Concerning the Application of the Contract Law of the People's Republic of China (II).)

Challenging liquidated damages clauses

- A different breach from the breach referred to in the liquidated damages clause – out of scope.
- A liquidated damages clause is invalid or void for uncertainty.
- Failure to comply with a condition precedent to a party's right to deduct or claim liquidated damages.
- Time has become "at large" and so the clause falls away.
- The clause is a penalty.

Lessons for Drafters and Contractual Estoppel

Philippe Kuhn

The main lessons for drafters of commercial and construction contracts

1. The penalty doctrine has been increasingly reduced to the margins post-*Makdessi*. The argument is often run, but rarely successful. Accordingly, for the likely paying party --- take great care in agreeing to the amounts and triggers.

2. Whether the penalty doctrine is engaged or not is usually not a sufficiently fact-sensitive issue to warrant a trial (i.e. to avoid strike-out/summary judgment), provided the clause is expressed in clear and unambiguous terms, with amounts and time periods from (and to) which they run specified. This can lead to a quick win for claimants. Disproportionality of amount is more likely to warrant a trial.

   [*Note again the general approach in *Triple Point* to LD clauses being presumed to run to termination absent specific wording]

The main lessons for drafters of commercial and construction contracts

3. Considering what would be a **genuine pre-estimate of loss** remains a convenient way of ensuring that the *Makdessi* test of proportionate to a legitimate test is not failed.

4. The penalty doctrine only applies upon breach --- this raises the tricky issue of **conditional primary obligations**.

5. Labelling of a clause as a penalty is not definitive. It is a question of **substance over form**.

6. Similarly, the mere fact of a recital in a contract or wording in a LD clause stating that the paying party considers a payment amount reasonable or fair is unlikely to be definitive: **the "contractual estoppel" question**.

Contractual estoppel?

- The point was recently touched in the Comm Ct by Richard Salter QC in *Heritage Travel and Tourism Ltd v Windhorst* [2021] EWHC 2380 (Comm).

- The penalty doctrine was considered in the context of a contractual clause, agreed as part of a settlement (Clauses 3.1(b) and (c) of the June Settlement) requiring payment in certain events of a Daily Lump Sum of EUR 139,134.

Contractual estoppel? – *Heritage Travel*

In consideration for the full and final satisfaction of the Proceedings and settlement of the Disputes, the Obligors shall pay unconditionally and irrevocably to the Claimants to the Settlement Account (and, in relation to such payment, Tennor shall on the date of such payment notify the recipient of the payment in writing) the following:

…

*b) subject to paragraph c) below, for value by no later than 15 February 2021, an amount equal to EUR 69,197,440.30 plus a daily lump sum payment of EUR 139,134 (if the full EUR 69,197,440.30 remains outstanding otherwise reduced pro rata) which shall accrue pro rata on the unpaid amount from 27 May 2020 until payment has been made in full (the "Second Amount"). **The daily lump sum payment has been negotiated and agreed between the parties as being a fair reflection of the value to the Claimants of ensuring compliance by the Obligors with the terms of this Settlement Agreement:***

…

[the contract also provided for an alternative amount]

Contractual estoppel? – *Heritage Travel*

- Richard Salter QC at [97]:

In the course of his submissions, Mr Salzedo told me that his team had calculated that, on the EUR 69m principal of the Second Amount, the Daily Lump Sum was equivalent to a rate of 6.1% per month or 73% per annum. I cannot on the limited evidence before me say that it is not at least properly arguable that that rate is disproportionate to the Claimants' legitimate interests. These matters were not fully explored in the evidence before me, and ***I am not attracted by the suggestion that the recital at the end of clause 3.1(b) determines the issue of disproportion in the Claimants' favour under the doctrine of contractual estoppel****. My present inclination (though, as the matter was not fully argued, I express no concluded view) would be to say that* ***such an approach would be inconsistent with the public policy basis of the penalty doctrine****. In the circumstances, had it been necessary for me to consider the question of disproportion, I would have held that the right course was for me to leave that question to be more fully explored at trial.*

Contractual estoppel? – *Heritage Travel*

- On the facts of *Heritage Travel* - Judge had found that penalty doctrine only engaged to a limited extent due to "payable on breach" requirement – see [89]-[92]

- Question of disproportionality of amount therefore considered on an *obiter* basis at [93]-[97]

- *Heritage Travel* [97] touches on a contractual estoppel notion. Provisional conclusion seems sensible.

Contractual estoppel? – *Heritage Travel*

- **Principled reasons:**
  - Whether a clause is penal or not has never turned on labelling: *Dunlop Pneumatic* to *Makdessi*
  - In other contexts, e.g. restrictive covenants in employment contracts, the courts similarly don't attach any real weight to clauses saying restrictions are reasonable. Commercial contracts may be more arms-length but risk of inequality of bargaining power also in play
  - Penalty doctrine is a not a consensual doctrine – it is public policy policing contractual terms agreed by the parties

Are Liquidated Damages Payable When Work is Never Completed or Accepted?

Alexander Burrell

Main Issues for Supreme Court

- **Issue 1**:
  Was PTT entitled to liquidated damages for delay in respect of work which had not been completed/accepted before the contract was terminated?.

- **Issue 2**:
  Did an exception from the contractual cap on damages for "negligence" remove from the cap losses caused by Triple Point's negligent breach of contract or only losses for the commission of some independent tort?

Basic Background

- Neither party incorporated in England & Wales, contract not performed in England & Wales.
- English law governing law.
- Triple Point agreed to provide PTT with software and software implementation services. There were two phases to the project: each with 9 stages. Triple Point was to be paid in successive stages by reference to these stages.
- Work proceeded slowly. Triple Point completed the first two of eighteen stages some 149 days late. PTT paid Triple Point for that work.
- Triple Point demanded payment for the other stages which it had not completed. PTT refused to pay. In response Triple Point suspended work and left the site. PTT maintained that this suspension was wrongful and terminated the contract.
- When Triple Point sued for the outstanding sums it had claimed, PTT counterclaimed damages for delay and due upon termination of the contract.

The LD Clause

Article 5.3:

"*If CONTRACTOR fails to deliver work within the time specified and the delay has not been introduced by PTT, CONTRACTOR shall be liable to pay the penalty at the rate of 0.1% (zero point one percent) of undelivered work per day of delay* ***from the due date for delivery up to the date PTT accepts such work****, provided, however, that if undelivered work has to be used in combination with or as an essential component for the work already accepted by PTT, the penalty shall be calculated in full on the cost of the combination.*"

(emphasis added)

High Court & Court of Appeal on Issue 1

High Court

- Jefford J held that the liquidated damages applied up to the date of termination, thereafter damages were at large. This was considered to be the orthodox analysis.

Court of Appeal

- Sir Rupert Jackson gave the only judgment with which Floyd and Lewison LJ agreed.
- Jackson conducted an extensive review of the authorities dealing with the position where the contractor fails to complete and a second contractor steps in, dividing them into three categories.
    - Category 1, the liquidated damages clause does not apply if the contract is terminated. In establishing this category, Sir Rupert Jackson relied primarily on a Scottish case in the House of Lords, *British Glanzstoff Manufacturing Co Ltd v General Accident, Fire and Life Assurance Corpn Ltd* [1913] AC 143.
    - Category 2, the liquidated damages clause only applies up to the termination of the first contract and not thereafter.
    - Category 3, the liquidated damages clause applied all the way to completion by the replacement (second) contractor.
- The Court of Appeal held that Triple Point was a Category 1 case, the effect being the liquidated damages clause did not apply and damages were at large.

Court of Appeal Determinations on Issue 1 (as found by the Supreme Court)

The Supreme Court found that the Court of Appeal had made the following two determinations:

(1) The wording of Article 5.3 could be so close to the wording in *Glandzstoff* that this authority was binding.

(2) It should not be assumed that the liquidated damages clause had any operation beyond the precise event for which it expressly provided.

Supreme Court Judgment on Issue 1

CA Determination 1

- The Supreme Court did not agree with the Court of Appeal's first determination, finding that ***Glandzstoff***, rather than laying down any principle, was a case on the interpretation of a single contract. Lady Arden gave guidance on the limited circumstances when precedents concerned with the interpretation of contracts would be binding. Such precedents deal with "*market-accepted wording or clauses from some standard form recognised in the industry*". These would bind in later cases involving the same wording [30].

CA Determination 2

- The Supreme Court also did not agree with the second determination. In Lady Arden's view the difficulty with the Court of Appeal's approach was that it was inconsistent with '*commercial reality'* and the '*accepted function of liquidated damages'* [35]. Parties agree a liquidated damages clause to provide a remedy that is predictable and certain for a particular event (e.g. delay in completion). Lady Arden held that parties must be taken to know the general law, that liquidated damages come to an end on termination (at which point the parties' contract is at an end and damages are at large) [35]. Thus parties do not have to specifically provide for the effect of termination in respect of liquidated damages. They can take that consequence as read.

In Short

- In short, the common law provides that liquidated damages come to an end on termination, unless specifically provided otherwise.

- When there is a liquidated damages provision which specifically provides that it ceases on completion or acceptance of works, this is in addition to (as opposed to substitution for) it ceasing on termination [35] – [36].

- This reading meets commercial common sense and prevents the unlikely elimination of accrued rights.

Implications

The following conclusions can be taken away from the Supreme Court Judgment on Issue 1:

1. A previous judgment cannot be binding as to the meaning and effect of a contractual clause, unless they fall within certain specified exceptions (i.e. market accepted wording/standard form contract clauses) [30].

2. In circumstances of termination, liquidated damages clauses are to be presumed to apply up to the date of termination, unless the clause specifically provides differently [35] (Category 2 out of the three Court of Appeal categories).

3. When interpreting contracts, regard must be had to commercial common sense [35].

4. Throughout the judgment, the Supreme Court (in particular Lady Arden and Lord Leggatt) signalled their support for liquidated damages clauses, which may have implications for the future interpretation of such clauses.

Guidance in *Triple Point* Case On How Do Courts Interpret Limitation of Liability Provisions

Vivek Kapoor

Limitation of Liability, subject to exceptions

"All those in favour of dropping 'limited liability' for 'no liability'."

Operation of the Liability Cap (1/2)

Both the Court of Appeal and the Supreme Court dissected Article 12.3 into four parts:

1. Triple Point was liable to pay for the damage suffered by PTT arising from its breach of contract. Express reference to software defects and contractual functionality requirements were made here.

2. Triple Point's total liability to PTT under the contract was capped at the contract price received by Triple Point under the contract (i.e. a global cap).

Operation of the Liability Cap (2/2)

3. Except for specific remedies expressly identified elsewhere in the contract, PTT's only remedy for claims under the contract was for Triple Point to use best endeavours to cure the breach, or failing that, for Triple Point to return the fees it received for the services or deliverables related to the breach (i.e. a limitation on the form of remedy).

4. Liability resulting from fraud, negligence, gross negligence or wilful misconduct were carved out from the limitation on liability (i.e. the cap carve-out).

Issues came before the Supreme Court

1. Whether an exception from the cap in article 12.3 for negligence removed from the cap losses caused by Triple Point's negligent breach of contract OR only losses for the commission of an independent or freestanding tort?

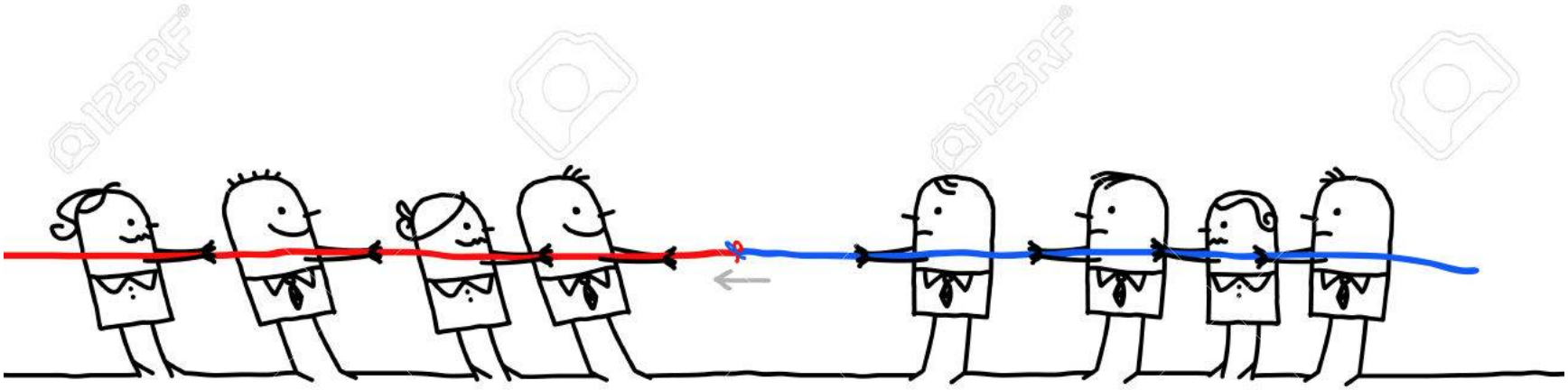
2. Whether liquidated damages payable by Triple Point were capped under article 12.3?

The Judgment

At the Supreme Court, *disagreed* with the Court of Appeal in that, in her judgment, liquidated damages fell within the cap carve-out if they resulted from a negligent breach of Triple Point's contractual obligation to use reasonable care and skill.

Subject to this carve-out for negligence, the Supreme Court *agreed* that liquidated damages fell within the global cap and were to count towards the maximum damages recoverable under the cap.

Negligence?



Key Takeaways

- Clear words are necessary before the court will conclude that a contract has taken away valuable rights or remedies which one of the parties to it would have had.

- The assumption is that parties normally do not give up valuable rights without making it clear that they intend to do so.

- Exceptions and carve-outs which are realistic, well-defined and in accordance with commercial sense are more likely to be upheld by the courts.

Postscript

Now, more than ever, parties to commercial contracts can be confident that English courts and arbitral tribunals applying English law will give effect to the risk allocation provisions that they have put in place.

This decision reflects the modern view of contractual interpretation - commercial parties are free to make their own bargains and allocate risks as they think fit.

The task of the court is to interpret the words used fairly by applying the ordinary methods of contractual interpretation.

Does a Void Limited Damages Clause Cap General Damages?

Eco World - Ballymore Embassy Gardens Co Ltd v Dobler UK Ltd
[2021] EWHC 2207 (TCC)

David Hopkins

Yes, of course it does

Wilmot-Smith on Construction Contracts (4th edn, May 2021), para 11.16:

> "*The textbooks, which discuss it, all agree that the employer cannot recover damages at a greater rate than the liquidated damages allowed for in the contract*."

Yes, of course it does

- *Keating on Construction Contracts* (11th edn, Dec 2020), para 10-029:

> "*It is submitted that it would be inequitable to permit an employer to avoid the effect of a provision which was penal in order to recover more. Further, where the nature of the clause is usually to limit the contractor's liability (as suggested above), there is every reason why the contractor should not be denied that limitation simply because the employer's estimate of its loss was not genuine*."

Yes, of course it does*

- ***Hudson's Building and Engineering Contracts*** (14th edn, Dec 2019), para 6-050:

  *"[…] treating liquidated damages as a "cap" on general damages appears to have been recognised since the early cases […]"**

* *"[…] the point may be open and a more precise statement of its rationale in construction cases is still awaited."*

And, in fact, all the textbooks were careful to warn readers that the point had not been decided by authority. For example, Wilmot-Smith states at para 11.15: "Some legal problems remain unresolved by authority. The principal one is what happens if the liquidated damages provision is discharged by the employer's default and the employer's actual losses by reason of the delay are greater than the losses provided for in the liquidated damages clause."

Yes, of course it does…?

- Charterparty cases (*Chitty on Contracts* (34th edn, law as of 31 July 2021), para 29-257):

> "*It is unsettled whether this principle applies to penalty clauses in other types of contract so as to entitle the claimant to ignore the sum stipulated as a penalty (where it was clearly not intended to limit liability) and to sue for damages for a greater amount to compensate him for his actual loss.*"

A question left open a long time ago …

- *Cellulose Acetate Silk Co Ltd v Widnes Foundry (1925) Ltd* [1933] AC 20, per Lord Atkin at 26:

> "*I desire to leave open the question whether, where a penalty is plainly less in amount than the prospective damages, there is any legal objection to suing on it, or in a suitable case ignoring it and suing for damages*."

… looking for a brave hero/ villain

- *Wilmot-Smith on Construction Contracts* (4th edn, May 2021), para 11.17:

> "It might be a surprisingly bold employer which argues that its provision for liquidated damages is a penalty and seeks to recover a greater sum. So far this has not been attempted."

Enter Eco World - Ballymore!

Eco World - Ballymore Embassy Gardens Co Ltd v Dobler UK Ltd [2021] EWHC 2207 (TCC) (O'Farrell J, 3 August 2021), para 2:

> "*EWB's position is that the liquidated damages clause is void and/or unenforceable. […] In those circumstances, EWB is entitled to claim general damages for delay, including any substantiated damages above the contractual liquidated damages cap*."

Eco World - Ballymore v Dobler

- JCT 2011 Construction Management Trade Contract
- Dobler to design, supply and install façade and glazing works in Blocks A, B and C of a building
- ***No*** provisions in Contract for completion in Sections
- But, contractual right for employer to take early possession

Eco World - Ballymore v Dobler

- Completion date (as varied) 30 April 2018
- 30 April 2018: Works incomplete
- 15 June 2018: EWB exercises contractual right to take possession of Blocks B and C, but does not certify PC in respect of those Blocks
- 20 December 2018: PC certified for all works

Eco World - Ballymore v Dobler

LDs clause:

- £Nil per week for the first four weeks
- "*Liquidated damages will apply thereafter at the rate of £25,000 per week (or pro rata for part of a week) up to an aggregate maximum of 7% of the final Trade Contract Sum*"

Eco World - Ballymore v Dobler

- At adjudication, ***Dobler*** argues the LDs clause is void for uncertainty/ penalty following 15 June 2018, as Blocks B and C were deemed practically complete by virtue of EWB taking possession, but the LDs clause did not make provision for reducing the amount of LDs following partial completion

- At the trial of the Part 8 claim, ***EWB*** now takes this position, and Dobler argues the opposite

- O'Farrell J holds the LDs clause is not void, but, helpfully, provides obiter judgment on the position if it was void

Eco World - Ballymore v Dobler

- *Cavendish Square Holding BV v Makdessi* [2015] UKSC 67; [2016] AC 1172: a penalty clause is wholly unenforceable

- *Eco World - Ballymore*, para 111:

> "*However, it does not follow that such provision will have no contractual effect; even where a liquidated damages clause is found to be wholly unenforceable as a penalty, it may on a true construction be found to operate as a limitation of liability provision*."

Eco World - Ballymore v Dobler

LDs clause:

- £Nil per week for the first four weeks

- "*Liquidated damages will apply thereafter at the rate of £25,000 per week (or pro rata for part of a week)* ***up to an aggregate maximum of 7% of the final Trade Contract Sum***"

Eco World - Ballymore v Dobler

Eco World - Ballymore, para 116:

> *"[…] the objective understanding of the parties in the commercial context of the Contract would be that the provision served two purposes:*
>
> *first, to provide for, and quantify, automatic liability for damages in the event of delay;*
>
> *second, to limit Dobler's overall liability for late completion to a specific percentage of the final contract sum."*
>
> (Paragraph breaks added)

Takeaways

- Obiter, but
  - First judgment on this point to deal with it in any detail
  - O'Farrell J, experienced TCC judge with construction background
- A void LDs clause *can* be a cap on general damages

Takeaways

- But only if, on its true construction, it also serves to limit the contractor's overall liability for delay

- Suggests that a void LDs clause which does not limit liability would ***not*** be a cap, and the employer could sue for unlimited damages

- Check your LDs clauses!