

Deconstructed Liquidated Damages: Review of Recent Developments

Part One

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Deconstructed Liquidated Damages: Review of Recent Developments

Marion Smith QC

The Basic Questions: When, Why and Where?

- **When?**

What are the historical origins of the doctrine against penalties?

- **Why?**

What are the advantages of liquidated damages clauses?

- **Why?**

What is the justification for the doctrine?

- **Where?**

Are liquidated damages clauses (and similar) used in construction and energy contracts?

What did *Makdessi* not decide?

- **The doctrine was not abolished**
 - What was the argument
 - Could their Lordships?
 - Would their Lordships?
 - Was a golden opportunity passed up?
 - Abolition by the back-door?
- **No judicial modification allowed**
 - What was the argument? *Jobson v. Johnson* [1989] 1 WLR 1026
 - What was the answer?
 - Relief against forfeiture

What's covered?

- **What is the true test of a penalty?**
Joe-han Ho
- **Does the control apply only where there is a breach of contract?**
David Brynmor Thomas QC
- **How is the test of a penalty being applied in the courts?**
Anna Lintner
- **What kind of default does the doctrine apply to?**
Ben Olbourne
- **Does it apply where partial performance has taken place?**
Juan Lopez

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Joe-han Ho

What did *Cavendish* decide?

- **[32] (per Lords Neuberger and Sumption, with whom Lord Carnwath agreed):** *“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.”*
- **[152] (Lord Mance):** *“What is necessary in each case is to consider, first, whether any (and if so what) legitimate business interest is served and protected by the clause, and, second, whether, assuming such an interest to exist, the provision made for the interest is nevertheless in the circumstances extravagant, exorbitant or unconscionable.”*
- **[255] (Lord Hodge):** *“the correct test for a penalty is whether the sum or remedy stipulated as a consequence of a breach of contract is exorbitant or unconscionable when regard is had to the innocent party's interest in the performance of the contract.”*

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David Brynmor Thomas QC

The Rule against Penalties: Application to Secondary obligations only (1)

Andrews v Australia and New Zealand Banking Group Ltd

(2012) 247 CLR 205

“In general terms, a stipulation prima facie imposes a penalty on a party (the first party) if, as a matter of substance, it is collateral (or accessory) to a primary stipulation in favour of a second party and this collateral stipulation, upon the failure of the primary stipulation, imposes upon the first party an additional detriment, the penalty, to the benefit of the second party. In that sense, the collateral or accessory stipulation is described as being in the nature of a security for and in terrorem of the satisfaction of the primary stipulation. If compensation can be made to the second party for the prejudice suffered by failure of the primary stipulation, the collateral stipulation and the penalty are enforced only to the extent of that compensation. The first party is relieved to that degree from liability to satisfy the collateral stipulation.”

The Rule against Penalties: Application to Secondary obligations only (2)

Makdessi

(Lord Neuberger and Lord Sumption, with whom Lord Carnwath agreed)

“Thirdly, the High Court’s redefinition of a penalty is, with respect, difficult to apply to the case to which it is supposedly directed, namely where there is no breach of contract. It treats as a potential penalty any clause which is “in the nature of a security for and in terrorem of the satisfaction of the primary stipulation.” By a “security” it means a provision to secure “compensation ... for the prejudice suffered by the failure of the primary stipulation”. This analysis assumes that the “primary stipulation” is some kind of promise, in which case its failure is necessarily a breach of that promise. If, for example, there is no duty not to draw cheques against insufficient funds, it is difficult to see where compensation comes into it, or how bank charges for bouncing a cheque or allowing the customer to overdraw can be regarded as securing a right of compensation.”

The Rule against Penalties: Application to Secondary obligations only (3)

Makdessi

(Lord Neuberger and Lord Sumption, with whom Lord Carnwath agreed)

“Finally, the High Court’s decision does not address the major legal and commercial implications of transforming a rule for controlling remedies for breach of contract into a jurisdiction to review the content of the substantive obligations which the parties have agreed. Modern contracts contain a very great variety of contingent obligations. Many of them are contingent on the way that the parties choose to perform the contract. There are provisions for termination upon insolvency, contractual payments due on the exercise of an option to terminate, break-fees chargeable on the early repayment of a loan or the closing out of futures contracts in the financial or commodity markets, provisions for variable payments dependent on the standard or speed of performance and “take or pay” provisions in long-term oil and gas purchase contracts, to take only some of the more familiar types of clause. The potential assimilation of all of these to clauses imposing penal remedies for breach of contract would represent the expansion of the courts’ supervisory jurisdiction into a new territory of uncertain boundaries, which has hitherto been treated as wholly governed by mutual agreement.”

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Anna Lintner

Recent applications of the *Makdessi* test

- ***De Havilland Aircraft of Canada Limited v Spicejet Limited*** [2021] EWHC 362 (Comm) (appeal outstanding)
 - Determination of penalty clause issue in summary judgment / strike out application
 - Relevance of evidence in determining whether a liquidated damages clause is a penalty
- ***Permavent Limited v Makin*** [2021] EWHC 467 (Ch)
 - Application of *Makdessi* to clause in a settlement agreement
 - Example of protected interest that is broader than immediate financial loss
 - Relevance of evidence of subsequent events

Deconstructed Liquidated Damages: Review of Recent Developments

Ben Olbourne
(Singapore / London)

What defaults, other than delay, does the doctrine against penalties apply to?

- **Non-completion of works (cf. delay in completion)**
 - *GPP Big Field LLP v Solar EPC Solutions SL*
[2018] EWHC 2866 (Comm)
- **Restraints of trade**
 - *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd*
[1915] AC 79
 - *Cavendish Square Holding BV v Talal El Makdessi*
[2015] UKSC 67 (doctrine applies not just to agreed damages stipulations, also to provisions relating to deposits, to forfeiture of property and to transfers below full value)
 - *Permavent Ltd v Makin* [2021] EWHC 476 (Ch)
- **Non-delay LD clauses**
 - *Bluewater Energy Services BV v Mercon Steel Structures BV*
[2014] EWHC 2132 (TCC) (resignation/replacement of key personnel)

What defaults, other than delay, does the doctrine against penalties apply to? [Continued...]

- **Non-compliance with terms of license**

- *ParkingEye Limited v Beavis* [2015] UKSC 67

- **non-payment of rent**

- *Vivienne Westwood Ltd v Conduit Street Development Ltd* [2017] EWHC 350 (Ch) (collateral agreement and resurrection of primary agreement)

- **non-payment / default in repayment under loan agreements and settlement agreements**

- *Campbell Discount Co v Bridge* [1962] AC 600 (hire purchase agreement)

- *Ahuja Investments Ltd v Victorygame Ltd* [2021] EWHC 2382 (Comm) (default interest)

- *Cargill International Trading Pte Ltd v Uttam Galva Steels Ltd* [2019] EWHC 476 (Comm)

- *Heritage Travel and Tourism Ltd v Windhorst* [2021] EWHC 2380 (Comm)

What defaults, other than delay, does the doctrine against penalties apply to? *[Continued...]*

- **Acceleration provisions**

- *The Angelic Star*
[1988] 1 Lloyd's Rep 122
- *ZCCM Investments Holdings Plc v Konkola Copper Mines Plc*
[2017] EWHC 3288 (Comm)
- *Heritage Travel and Tourism Ltd v Windhorst*
[2021] EWHC 2380 (Comm)

Eco World Ballymore Embassy Gardens Company Limited v Dobler UK Limited

(2021) EWHC 2207 [TCC; O'Farrell J]

Juan Lopez

Liquidated Damages Clauses: Essentials

- Stipulating money payable as damages for loss caused by breach of contract, irrespective of actual loss
- May/may not additionally amount to exclusion clause or limitation of liability clause
- Certainty/Enforceability (vs. uncertain/penal) of LDCs: e.g.: *Bramall & Ogden v Sheffield City Council*; *Taylor v Woodrow Holdings Limited v Barnes & Elliott Limited*; and *De Havilland Aircraft of Canada Ltd v SpiceJet Ltd*, etc.

Eco World

- Operation of LDC in context of a part performance / part take-over of contract works
- Claim for declaratory relief & damages
- Proper interpretation of LDC in contract between EWB (C) and Dobler (D) for design/supply/installation of glazing works where EWB took over part of contract works (and signposted agreement to complete) before practical completion of works
- Contract permitted EWB to take part possession of works, ahead of practical completion
- Part possession not contractually provided for through reduction in liquidated damages
- EWB argued: LDC was invalid/inoperative + entitlement to general damages for delay (including substantiated damages, exceeding liquidated damages cap)

Eco World: Issues

- (1) Validity and enforceability of LDC: Whether LDC is penal vis-à-vis other provisions governing part take-over of works and mechanism for adjusting-down liquidated damages, reflecting part take-over
- (2) [Alternatively] Entitlement to claim general damages [delay]
- (3) If an entitlement to claim general damages [delay], whether recovery should be limited by any void/unenforceable LDC

Eco World: The LDC

- *“2.32.1 If the Trade Contractor fails to complete the Works or works in a Section by the relevant Date for Completion of a Section or the Works, the Employer may, not later than 5 days before the final date for payment of the amount payable under clause 4.16, give notice to the Trade Contractor which shall state that for the period between the relevant Date for Completion of a Section or the Works and the date of practical completion of the Works or Section that:*
- *2.32.1.1 he requires the Trade Contractor to pay liquidated damages at the rate stated in the Trade Contract Particulars, or lesser rate stated in the notice, in which event the Employer may recover the same as a debt; and/or*
- *2.32.1.2 that he will withhold or deduct liquidated damages at the rate stated in the Trade Contract Particulars, or at such lesser stated rate, from sums due to the Trade Contractor.*
- *2.32.2 If the Employer intends to withhold or deduct all or any of the liquidated damages payable, an appropriate Pay Less Notice must be given by or on behalf of the Employer.”*

Makdessi

- Supreme Court: *“the real question when a contractual provision is challenged as a penalty” being “whether it is penal, not whether it is a pre-estimate of loss” by which enforceability will depend on “whether the means by which the contracting party’s conduct is to be influenced are unconscionable or extravagant by reference to some norm”. The “true test” was there characterised as “...whether the impugned provision is a secondary obligation which imposes a detriment on the contract-breaker out of all proportion to any legitimate interests of the innocent party in the enforcement of the primary obligation.”*
- *“...whether the sum or remedy stipulated as a consequence of a breach of contract is exorbitant or unconscionable when regard is had to the innocent party’s interest in the performance of the contract. Where the test is to be applied to a clause fixing the level of damages to be paid on breach, an extravagant disproportion between the stipulated sum and the highest level of damages that could possibly arise from the breach would amount to a penalty and thus be unenforceable. In other circumstances the contractual provision that applies on breach is measured against the interest of the innocent party which is protected by the contract and the court asks whether the remedy is exorbitant or unconscionable.”*
- Consequence of a ‘penal’ LDC: becomes wholly unenforceable (rejecting any suggestion of partial enforceability, on reduced basis, reflecting actual loss suffered by breach).

O'Farrell J:

- Considers trite principles of interpretation and LDCs, accounting for:
 - natural and ordinary meaning; other relevant contractual provisions
 - overall purpose of clause, and contract
 - circumstances known to/assumed by parties at date of contract
 - commercial common sense
- LDC contemplated a failure to meet: (a) contractual dates completing various sections of works, and/or (b) the contractual date for whole of works – but not for an alternative rate of liquidated damages applicable to a late completion affecting part of works. [Contract did not include mechanism for adjusting the rate of liquidated damages payable after EWB effected part take-over]. So, provisions were found to be clear and certain
- Applying natural and ordinary meaning of LDC, a failure by Dobler to achieve practical completion of works meant EWB was entitled to liquidated damages at rate set out in contract particulars

O'Farrell J:

- Upon taking over of part of the works, EWB had effectively excluded Dobler from part of site, so Dobler was no longer obligated to work in that part
- Dobler not entitled to any relief from liquidated damages to reflect the take-over, meaning that full rate of liquidated damages continued to apply in respect of the reduced scope of outstanding works
- In principle, a “one rate” LDC is capable of enforceability even if part completion or part possession, without any related reduction in liquidated damages payable. [EWB argued that use of a “one rate” liquidated damages clause for late completion of any combination of blocks onsite, did not reflect the reality that different levels of loss would be incurred, or where EWB had taken over part of the works (see *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co*: possible presumption of a penal clause)]
- LDC penal/unenforceable? LDC not “unconscionable” or “extravagant” as to be penal (applying Makdessi)

O'Farrell J:

- But, LDC was a secondary obligation, imposing a detriment on Dobler, being proportionate to the legitimate interest of EWB in enforcing the primary obligation of completing the works in accordance with the contract, noting: (a) LDC had been fully negotiated by professionals (so, Court slow to intervene in commercial freedoms, especially those governing how risk of delay in works completion is managed: Makdessi); (b) EWB held legitimate interest in enforcing primary obligation of Dobler to complete works as a whole; delay would likely impact on the work of subsequent trade contractors/cause wider disruption to completion; (c) Quantification of damages suffered by EWB would be arduous (contrast ease of advance fixing of liquidated damages payable for late completion of works); (d) Level of damages not evidenced as being unreasonable or disproportionate to likely loss caused by late completion
- Rejected Dobler's (alternative) argument that even if the LDC is penal and void, general damages should nevertheless be limited to the level of liquidated damages, by reference to the LDC itself

Eco World: Significance

- Operability of LDC in context of a part performance / part take-over of contract works
- Interpretation of LDC, applying *Makdessi* principles + rules securing commercial freedoms to formulate key contractual terms, reflecting their functionality (especially for major contracts)
- LDCs remain useful: underscoring sum of financial loss for delays and limiting contractor exposure to future liabilities, whilst ensuring compensation recovery