CONSTRUCTION : BULLETIN

Liquidated Damages – What's Enforceable?

It is common practice in construction contracts to include a provision that enables the employer to deduct liquidated damages from the contractor in the event of certain specified breaches, the most common of which is failure to complete the works on time.

A liquidated damages clause gives the contractor the advantage of knowing with a reasonable degree of certainty the extent of his liability if he commits a particular breach of contract. By agreeing liquidated damages, the parties can avoid the need for costly and lengthy legal proceedings to determine the employer's loss in the event the specific breach occurs (assuming the liquidated damages are not subsequently challenged by the contractor). It also means that the employer does not have to prove that he has actually suffered a loss as a result of the contractor's breach.

Will liquidated damages always be upheld?

The courts recognise the benefits of liquidated damages and are keen to enforce them if they have been agreed by the parties. However, the courts have traditionally refused to enforce liquidated damages which are deemed to be a "penalty". Liquidated damages must be a "genuine pre-estimate of loss" in order to be upheld by the courts.

What is a genuine pre-estimate of loss?

Liquidated damages should, as far as possible, be set at a figure which reflects the likely loss the employer would suffer if the contractor committed the specified breach. Whilst the courts recognise that it can be difficult to accurately estimate potential future losses, the employer should try his best to ensure there is some logical basis to his liquidated damages calculation. This might be achieved by explaining the calculation to the contractor in a pre-contract meeting and recording evidence of that meeting as a contract document.

The employer's pre-estimate does not have to be right to be reasonable and the fact that estimating the precise loss is difficult or impossible does not prevent liquidated damages from being a genuine pre-estimate. Attempting to challenge liquidated damages on the grounds that the actual loss incurred by the employer is lower than the specified level of liquidated damages will not generally result in a finding that the employer had not made a genuine pre-estimate.

What is a penalty?

If the level of liquidated damages is so high that it effectively acts as a deterrent to prevent the contractor from breaching the contract, rather than being a genuine pre-estimate of the employer's loss, it will usually be classed a penalty and may be held to be unenforceable.

Whether or not a clause is a penalty must be judged at the date the agreement was entered into. If it was not penal at that date, it cannot become so as a result of later events. However, that is not to say later events are irrelevant, as they can shed light on what the employer's loss was reasonably expected to be at the time the contract was made.

There must be a substantial discrepancy between the level of

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liquidated damages and the loss which is likely to be suffered by the employer in order for liquidated damages to be classed as a penalty.

Where the same liquidated damages sum is payable upon the occurrence of a range of breaches, some serious and others trivial, there will generally be a presumption that the clause is a penalty.

The changing approach of the courts

As explained above, the courts would traditionally refuse to uphold any liquidated damages clause which was not a genuine pre-estimate and constituted a penalty.

However, recent cases have highlighted a change in the courts' approach. The courts have indicated that even if a liquidated damages clause does not represent a genuine pre-estimate of the loss suffered, it may not necessarily be unenforceable, provided that there was a commercial justification for the liquidated damages clause and its predominant purpose was not to act as a deterrent against breach.

In the recent case of *El Makdessi v Cavendish Square Holdings* (2013), the Court of Appeal adopted a two stage approach, first considering whether the liquidated damages were a penalty or a genuine pre-estimate of loss, and then going on to consider whether there was commercial justification for the liquidated damages even though they were a penalty.

When will a penalty have commercial justification?

Perhaps unsurprisingly, what constitutes commercial justification for a penalty is not always clear-cut. The question will always turn on the specific facts of the case. Where there have been extensive negotiations over the liquidated damages clause, this may help to establish commercial justification, but there is no guarantee of this.

In the *El Makdessi* case, the Court of Appeal found that the liquidated damages were a penalty and were not commercially justifiable. The sum the seller stood to lose as a result of the specified breaches was out of all proportion to the amount of liquidated damages which the seller was entitled to deduct. The dominant purpose of the liquidated damages was obviously to deter the buyer from breaching the contract.

In contrast, in the case of *Azimut-Benetti v Healey* (2010), the court found that a liquidated damages clause was commercially justifiable because of the need for the employer to avoid the inevitable delay of trying to prove and recover actual losses arising out of a breach.

Summary

The question of whether liquidated damages will be enforced or not is no longer as clear cut as it once was. Liquidated damages provisions which are classed as a penalty would once have been unenforceable, but can now be "saved" if there is commercial justification for the penalty.

It is clear that care needs be taken when deciding what level of liquidated damages should apply to a contract. Thought needs to be given to how the level of liquidated damages should be calculated and justified.

If the level of liquidated damages is high, but there is a commercial justification for this, it would be helpful to keep detailed records of how the liquidated damages were arrived at, what negotiations were conducted and the reasons why a high rate of liquidated damages has been agreed. This information should be included within the contract to ensure it can be taken into consideration later on.

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