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How should LADs be approached and or calculated and why?

Simon Tolson
Fenwick Elliott LLP

white paper

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The basics…so what are liquidated damages?

Well…

- Commercial contracts often include a clause agreeing that a set amount of money will be paid (or some other remedy may take effect) **if** a particular provision of the contract is **breached**.

- The parties to the contract make make a genuine assessment of the losses which are *likely* to result in the event of breach, and stipulate that such sum shall be payable in the event if breach.

- The claimant will not receive more than that sum.

- NO action will be allowed for unliquidated damages so long as it sticks.

Liquidated damages will be limited to the amount stipulated by the contract

- Where the contract has underestimated damages in the event of a breach, either because of inflation or through bad bargaining, damages will be limited to the amount stipulated by the contract.

- *Cellulose Acetate v Widnes Foundries* [1933]

Cellulose Acetate v Widnes Foundries (1933)…(old law)

A clause is more likely to be considered as a Penalty Clause if:

- (a) the amount stipulated is extravagant and unconscionable , as compared to the greatest loss that could conceivably be proved to have followed from the breach;

- (b) if the breach consists only in not paying a sum of payment, and the sum stipulated is a sum greater than the sum which ought to have been paid.

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Cellulose Acetate v Widnes Foundries

In *Widnes Foundries* the defendant agreed to build a chemical plant for the plaintiff in 18 weeks. If it took longer than this, they agreed to pay 'by way of penalty £20 per working week'.

The defendant completed 30 weeks late, and the plaintiff lost £5,850 as a result of the delay.

The defendant argued that they were only liable for £600 damages. The plaintiff was held only to be able to recover £600.

The clause was not a penalty clause although it was described as such, because its object was not to act in terrorem.

The parties must have known that the actual loss would be more than £20 per week, and the clause would, therefore, appear to have been an attempt to limit liability.

Liquidated damages – old law

- A clause that is intended to punish the contract-breaker is void. The Court will ignore such clause – Claimant can sue for actual loss *Wall v Rederiaktiebolaget Luggude* [1915] 3 KB 66
- As long as the damages figure was not extravagant, it is often be considered as a true assessment of damages and not a penalty clause.

Liquidated damages – old law

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- As long as the damages figure was not extravagant, it is often be considered as a true assessment of damages and not a penalty clause.

If liquidated damages fail what of unliquidated?

- Whilst in *Wall v. Rederiaktiebolaget Luggude* it was held that, where a LDs figure was held to be inappropriate, the unliquidated damages which were proved to have been incurred could be levied in full even though they exceeded the amount of liquidated damages. In contrast the Canadian case, *Elsley v Collins Insurance Agency Ltd* (1978), provided an opposite view. The question of whether a general damages claim is limited to the amount of liquidated damages included in the contract was referred to in *Cellulose Acetate Silk Co Ltd v. Widnes Foundry* but was left open.

Attempt to identify penalty clauses – general position

The use of the words 'penalty' or 'liquidated damages' may be prima facie evidence, yet the expression used is not conclusive.

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

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 as of the time** of making the contract, **not** as at the time of breach.

The old order

- Students of construction law love writing papers about **the distinction between liquidated damages clauses and penalty clauses!**
- Traditionally, it has been relatively firm ground, and in particular, everybody trots out the dicta of Lord Dunedin in *Dunlop v New Garage*.

The old order

- If you have got one of those old papers, which spurts out the famous dicta of Lord Dunedin, you might as well bin it!

- Out of respect we should acknowledge what is being buried. *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd* see pages 5 to 8 of my paper.

Liquidated damages – *Dunlop Pneumatic Tyre Co v New Garage* (1915)

The defendant bought tyres from the plaintiff and agreed :

- Not to tamper with manufacturer's marks
- Not to sell below the list price
- Not to sell to any person blacklisted by the plaintiff
- Not to exhibit or export tyres without the plaintiff's consent.
- The defendant agreed to pay £5 for every tyre he sold or offered in breach of the agreement. In breach, the defendant sold to the public below the list price.
- The provision for payment of £5 was held not to be penal.
- Looking at the language of the contract itself, the character of the transaction and the circumstances, it was clear that the provision was to prevent a price war and so protect the plaintiff's sales.

Liquidated damages – *Dunlop Pneumatic Tyre Co v New Garage* (1915)

- Things have begun to change. Now there's been the double whammy decision from in highest court in the land, the UKSC, in *Cavendish v El Makdessi* and *ParkingEye Limited v Beavis*.

The law on the move

- Their Lordships in *Cavendish* recognised Lord Dunedin's speech in *Dunlop* "*achieved the status of a quasi-statutory code in the subsequent case-law*"…
- Though the parties to a contract may use the words 'penalty' or 'liquidated damages' and intend prima facie those words to mean what they say, 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 found in nearly every case.
- 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 (*Clydebank Engineering v Don Jose Yzquierdo*, p3 of my paper).

The old order…

- 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 (*Public Works Comr. v Hills and Webster v Bosanquet*).
- 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. Such are:

(a) It will be held to be penalty if the sum stipulated for is extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have followed from the breach. (Illustration given by Lord Halsbury in *Clydebank case*.)

The old order…

(b) It will be held to be a penalty if the breach consists only in not paying a sum of money

(c) There is a presumption (but no more) that it is a penalty when 'a single lump sum' is made payable by way of compensation:

- on the occurrence of one or more or all of several events
- some of which may occasion serious and others but trifling damage' (Lord Watson in *Elphinstone v Monkland Iron and Coal Co*).

The old order…

- On the other hand:

(d) It is no obstacle to the sum stipulated being a genuine pre-estimate of damage, that the consequences of the breach make precise pre-estimation almost an impossibility. On the contrary, that is just the situation when it is probable that pre-estimated damage was the true bargain between the parties (*Clydebank Case*, Lord Halsbury at p 11; *Webster v Bosanquet*, Lord Mersey)

NB: *Dunlop* was not a construction case, but these words have been picked over time and time again in construction cases, particularly by contractors who have finished late and who want to demonstrate that the liquidated damages provision in their contract is penal and hence inapplicable.

The old order…

- Since the decision in 1993 of *Philips v Attorney General of Hong Kong*, the courts have been increasingly cautious about finding these provisions to be penal.

The UKSC said emphasis was placed on the leading judgment of Lord Woolf in *Philips*, who stated:

- "*Except possibly in the case of situations where one of the parties to the contract is able to dominate the other as to the choice of the terms of a contract, it will normally be insufficient to establish that a provision is penal to identify situations where the application of the provision could result in a larger sum being recovered by the injured party than his actual loss..*"

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A new test for penalties – headline news…

- Blow for motorists as Supreme Court REJECTS chip shop owner's appeal over £85 parking charge.
- Chippie fined £85 by ParkingEye over 56 minute overstay.
- Barry Beavis went to court arguing the fine was 'excessive and unfair'
- But the Supreme Court dismissed his appeal.
- Ruling seen as a blow for motorists battling huge fines imposed by firms !

The question!

How do you approach the problem of a "genuine pre estimate of loss" being an inappropriate test for LADs in modern building contracts?

In other words, how should LADs be approached and or calculated?

New start… a review was needed

A review was needed. As Lord Neuberger observed at the commencement of his joint judgment with Lord Sumption (Lord Clarke JSC and Lord Carnwath agreed):

- "*The penalty rule in England is an ancient, haphazardly constructed edifice which has not weathered well, and which in the opinion of some should simply be demolished, and in the opinion of others should be reconstructed and extended. For many years, the courts have struggled to apply standard tests formulated more than a century ago for relatively simple transactions to altogether more complex situations.*" (para. 3)

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The restatement! Primary and secondary obligations – historical context … NEUBERGER AND SUMPTION :

7. Equity and law developed on wholly different lines. The equitable jurisdiction to relieve from penalties had been closely associated with the jurisdiction to relieve from forfeitures which developed at the same time. Both were directed to contractual provisions which on their face created primary obligations, but which during the 17th and 18th centuries the courts of equity treated as secondary obligations on the ground that the real intention was that they should stand as a mere security for performance.

The court then intervened to grant relief from the rigours of the secondary obligation in order to secure performance in another, less penal or (in modern language) more proportionate, way. In contrast, the penalty rule as it was developed by the common law courts in the course of the 19th and 20th centuries proceeded on the basis that although penalties were secondary obligations, the parties meant what they said. They intended the provision to be applied according to the letter with a view to penalising breach. The law relieved the contract-breaker of the consequences not because the objective could be secured in another way but because the objective was contrary to public policy and should not therefore be given effect at all. The difference in approach to penalties of the courts of equity and the common law courts is in many ways a classic example of the contrast between the flexible if sometimes unpredictable approach of equity and the clear if relatively strict approach of the common law.

Primary and secondary obligations distinguished

The Justices posed themselves this question: In what circumstances is the rule against penalties (RAP) engaged at all?

They said there is a fundamental difference between a jurisdiction **to review** the fairness of a **contractual obligation** and a jurisdiction **to regulate the remedy** for breach. The penalty rule regulates only the remedies available for breach of a party's primary obligations, not the primary obligations themselves. As they explained at para. 14:
"*Thus, where a contract contains an obligation on one party to perform an act, and also provides that, if he does not perform it, he will pay the other party a specified sum of money, the obligation to pay the specified sum is a secondary obligation which **is** capable of being a penalty; but if the contract does not impose (expressly or impliedly) an obligation to perform the act, but simply provides that, if one party does not perform, he will pay the other party a specified sum, the obligation to pay the specified sum is a conditional primary obligation and cannot be a penalty.*"

Primary and secondary obligations distinguished

Consequently, the application of the penalty rule may depend on how the obligation is framed in the contract: i.e. as a conditional primary obligation, or a secondary obligation providing a contractual alternative to common law damages. For example, a contract obliges party A to perform act Z, and further provides that if party A does not perform act Z, he will pay party B sum X. The obligation to pay sum X is a secondary obligation, capable of being a penalty. If the contract simply provides that if party A does not perform act Z he will pay party B sum X, that is a conditional primary obligation and cannot be a penalty.

All clear? Their Lordships acknowledged the "*capricious consequences of this state of affairs*", but emphasised that "the classification of terms for the purposes of the penalty rule depends on the substance of the term and not on its form or on the label the parties have chosen to attach to it" (para 16).

The restatement!

- Crucially, it makes clear the courts will not interfere with the commercial arrangements; the penalty issue applies only in relation to secondary obligations and not every clause requiring additional payment or a reduction in contract price will be a secondary obligation. While it is recognised that **whether a clause forms a primary or secondary obligation is a matter of substance rather than form**, there is also recognition that the drafting can make a difference to the treatment of the clause. Where a sanction for breach is intended to form a primary obligation, this must be made absolutely clear if the risk of it being held to be a penalty is to be avoided. Commercial context will be relevant: (i) the extent to which the contract has been negotiated; (ii) the bargaining powers of the parties; and, most importantly, (iii) the commercial grounds for imposing the sanction.

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The restatement!

https://www.supremecourt.uk/cases/uksc-2013-0280.html

- So to understand *how LADs should be approached and calculated* it must be understood that the UKSC in ***Cavendish Square Holding BV v Talal El Makdessi***; ***ParkingEye Limited v Beavis*** shifted the test away from a "genuine pre-estimate of loss" but declined to abolish the rule against penalties.

- Saying that the underlying rationale of the rule in English law has been misunderstood and that as a result the rule has been applied in many situations where it is both unnecessary and unjust.

The restatement!

- The new test is: **whether the clause is a secondary obligation which imposes a detriment which is out of all proportion to the legitimate interest of the innocent party**.

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The restatement!

- The Supreme Court rejected the traditional test of whether a clause that takes effect on breach is a "*genuine pre-estimate of loss*" and therefore compensatory, or whether it is aimed at deterring a breach and therefore penal.

- The decision helpfully recognises …that a party can, in some circumstances, have a *legitimate interest* in enforcing performance which goes beyond simply being compensated for losses.

The restatement!

- It recognises that the parties to a contract may be interested in the performance of the contract for more than purely monetary reasons.

The restatement!

- Thus the SC's decision introduces a more flexible test as to whether or not a clause will be found to be penal, and therefore unenforceable, than the traditional question of whether a clause was aimed at deterrence rather than compensation.
- The question of precisely what will amount to a *legitimate interest*, and whether a clause is *out of proportion to that interest*, may be open to debate.
- The decision provides a more helpful starting point, and is likely to mean less interference in contracts freely negotiated between commercial parties of similar bargaining power.

The restatement!

- The decision is also helpful in confirming that a clause may **fall outside the rule** against penalties altogether **if it** takes effect in circumstances other than a breach of contract, for example a payment which is conditional on performance rather than an entitlement to liquidated damages in the event of breach.
- It **may** therefore be possible to avoid the application of the RAP with careful drafting, though the judgment does make it clear that classification of the term will depend on substance rather than mere form.

The restatement!

- BUT this judgment is not a ‘magic’ solution for preventing a contractual sanction for breach from being regarded as an unenforceable penalty because what is a “legitimate interest” of the innocent party and whether the sanction is out of all proportion to it will depend on the facts and how the courts interpret them. It does, however, provide a welcome update to this area of law.

The restatement!

- The decision is consistent with the general trend of the courts in recent years to become more reluctant to interfere with the parties' freedom of contract and particularly so in a commercial context.

- This is highlighted by an acknowledgement in the lead judgment by Lords Neuberger and Sumption that:
- *"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".*

The restatement!

- Further, although the payment of money is the classic obligation under a penalty clause, the Supreme Court says there is no reason the rule should not apply to an obligation to transfer assets (either for nothing or at an undervalue). Lord Mance and Lord Hodge also consider that the rule applies equally to clauses withholding payments on breach, and could apply **alongside relief against forfeiture**. Lord Neuberger and Lord Sumption leave that latter very interesting question open. It is worth spending a moment on it…

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Forfeiture angles

For many construction lawyers, the concept of relief from forfeiture is a land law thing, learned at law school but largely forgotten since then.

Our eye has been taken off the ball that the doctrine might have anything much to do with penalties.

But consider a tenant who is late paying the rent, or some minor covenant in the lease. The lease (drafted as tough as nails by the landlord's lawyers can devise) gives the landlord the right to forfeit the lease in these circumstances.

We know that equity used to offer relief to the as it did to mortgagors. And that statute (1870) subsequently codified that relief. And that is because forfeiture would be an extravagant and disproportionate remedy.

The concept is not a million miles from that of penalties!

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Forfeiture angles…

- And this is what the Supreme Court has now drawn vivid attention to. The first speech of Lords Neuberger and Sumption (Lord Carnwath agreeing) set the scene:

- *"…The relationship between penalty clauses and forfeiture clauses is not entirely easy. Given that they had the same origin in equity, but that the law on penalties was then developed through common law while the law on forfeitures was not, this is unsurprising."*

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Forfeiture angles…

- The Supreme Court picked up and ran with a concept rolled out in ***BICC plc v Burndy Corpn*** [1985] Ch 232, namely that the court's approach is first to look at the penalty issue, and then, if not satisfied that the clause is penal, to then consider whether to grant relief from forfeiture. Lord Hodge said:
- "*There is no reason in principle why a contractual provision, which involves forfeiture of sums otherwise due, should not be subjected to the rule against penalties, if the forfeiture is wholly disproportionate either to the loss suffered by the innocent party or to another justifiable commercial interest which that party has sought to protect by the clause. If the forfeiture is not so exorbitant and therefore is enforceable under the rule against penalties, the court can then consider whether under English law it should grant equitable relief from forfeiture, **looking at the position of the parties after the breach** and the circumstances in which the contract was broken. This was the approach which Dillon LJ adopted in BICC plc v Burndy Corpn [1985] Ch 232 and in which Ackner LJ concurred. The court risks no confusion if it asks first whether, as a matter of construction, the clause is a penalty and, if it answers that question in the negative, considers whether relief in equity should be granted having regard to the position of the parties after the breach.*"

Forfeiture angles…

There are a number of interesting things about this.

- First, we have not hitherto gone down this track in construction law. The idea of the twofold test is new.
- Secondly, the second ground may be, at least in some cases, wider than the first i.e. the passage is predicated on the possibility that a clause might clear the penalty hurdle, but fall at the relief from forfeiture hurdle.
- Thirdly, this second hurdle involves a wider enquiry. The traditional view is that the penalty issue is judged as at the time of the contract, not the time of the breach, and this bit of *Dunlop* appears to survive. But the relief from forfeiture issue requires the court to look at what has actually happened (if anything) as a result of the breach.

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Forfeiture angles…

- Fourthly, consider the context of a notice provision, whereby a contractor forfeits their right to extensions of time, or loss and expense, or payment for variations, unless they give notice in a specified form by a specified time. That looks, at first blush, well within the forfeiture doctrine. And even though the court might decide that such a time bar is not penal, it might nevertheless conclude that the failure to give notice was in the event of no practical consequence whatsoever, since the owner knew perfectly well of the relevant event, of its likely impact on time and cost, and that the contractor would be making a claim for it. And so all of the legitimate purposes of the notice provision are otherwise satisfied. Should the court grant relief from forfeiture in these circumstances? It looks arguable, but again we will have to wait and see what courts do with the argument.

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Forfeiture angles…

- So, how had we all missed this?

- Partly, it is because it was widely assumed for a long time that the equitable doctrine of relief from forfeiture had been entirely subsumed by the statutory codification of the doctrine in the case of forfeiture of mortgages and leases.

Forfeiture angles…

- But in *Shiloh Spinners Ltd v Harding* [1973] AC 691 the House of Lords had said, "***Oh no. The old equitable doctrine still applies in other contexts***". That case was highlighted recently by the Privy Council in Cukurova *Finance International Ltd & Anor v Alfa Telecom Turkey Ltd* (British Virgin Islands) [2013] UKPC. This is how Lord Wilberforce had put it in *Shiloh*:

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Forfeiture angles... *Shiloh Spinners Ltd v Harding*

- "*There cannot be any doubt that from the earliest times courts of equity have asserted the right to relieve against the forfeiture of property. The jurisdiction has not been confined to any particular type of case…I would fully endorse this: it remains true today that equity expects men to carry out their bargains and will not let them buy their way out by uncovenanted payment. But it is consistent with these principles that we should reaffirm the right of courts of equity in appropriate and limited cases to relieve from forfeiture for breach of covenant or condition where the primary object of the bargain is to secure a stated result which can effectively be attained when the matter comes before the court, and where the forfeiture provision is added by way of security for the production of that result*."

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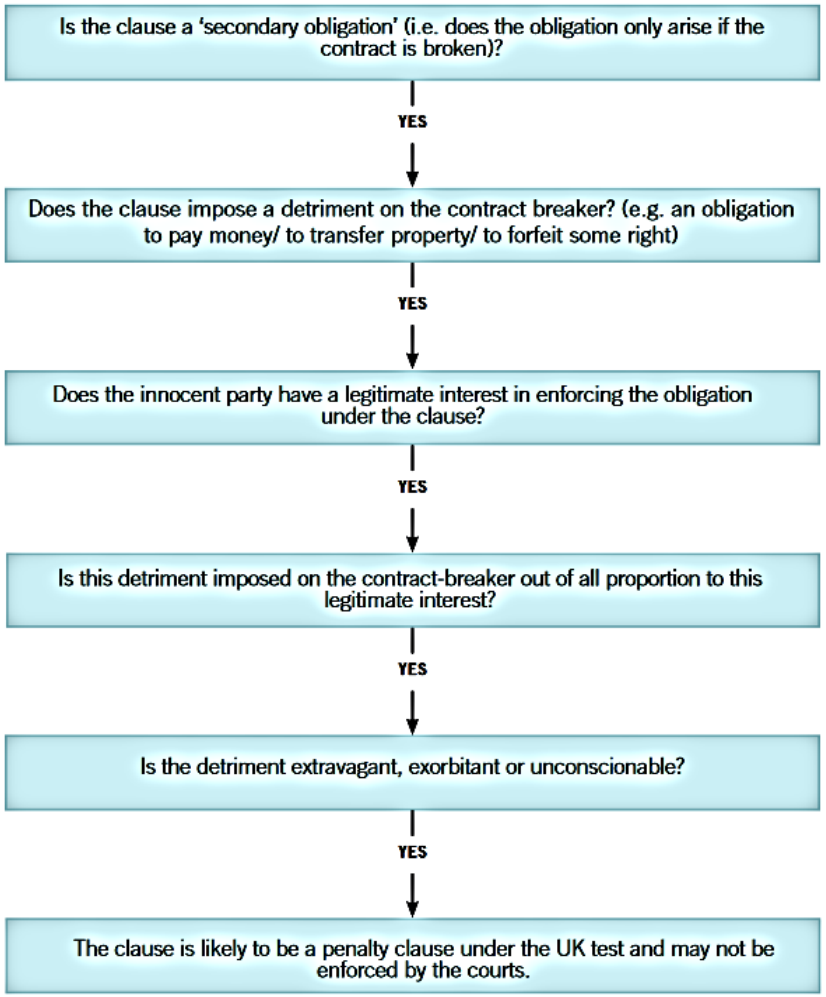
Identifying a penalty clause – SC approach



Identifying a penalty clause – SC approach

- The new test set out by the UK Supreme Court is more flexible, and it recognises that the parties to a contract may be interested in the performance of the contract for more than purely monetary reasons. The test also promotes contractual certainty and it gives parties more confidence that what the contract says will be enforced.

- However, there is still scope for dispute. A party seeking to uphold a clause which is being challenged as a penalty clause will highlight the legitimate interest it was seeking to protect by including the clause in the contract. On the other hand, the party challenging the validity of the clause will say that it imposes a detriment on it which is out of all proportion to this apparent 'legitimate interest' and is extravagant, exorbitant or unconscionable.

Identifying a penalty clause – SC approach

- Argument over what constitutes a 'legitimate interest' and what is meant by the terms 'extravagant, exorbitant or unconscionable' is inevitable. Each case will depend on its own facts. The key practice point that emerges here is that it is essential to document precisely what legitimate interest is being protected. In *Makdessi*, the Court of Appeal applied the penalties doctrine largely because no clear commercial justification could be established by *Cavendish* on the evidence.

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Tips on how to make it less likely that your LD is deemed to be a penalty

Although each case is decided on its facts, there are a number of guiding principles to be taken into account when drafting an LD clause, including:

- avoid specifying sums payable upon breach which are so high that they cannot be seen as commercially justifiable
- different types of breach should generally attract payment of different sums in order to be regarded in each case as a commercially 'safe'
- if the primary obligation is payment of a particular sum, then breach of this clause should not usually give rise to a payment of a much higher sum
- keep your calculations to show you have tried to assess likely damage for a particular breach
- include contractual wording to say that the parties agree that the sum of putative loss and not a 'penalty' (although not decisive, this kind of wording can at least be persuasive to the courts)
- if drafting a take or pay clause, consider whether the specified sum is commercially defensible, in the light of the recent judgments which have still not killed off the rule against penalties.

Thank you for listening. Any questions?