Penalties Revisited -
Implications for Liquidated
Damages Provisions in
Construction Contracts

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12 July 2016

Section 1
Introduction to Liquidated Damages in
Construction Contracts

Section 2
New English Law on Penalties: Cavendish
and Parking Eye

Section 3
Australia’s Position on the Law on Penalties

Section 4
Singapore, Hong Kong and the PRC

Section 5
Considerations Post-Cavendish

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What are Liquidated Damages

液度rewarded damages

- Specific amount
- Specified breach
- Capable of calculation
- With certainty
- In advance

- A payment for a breach of contract
- To compensate for the consequence of the breach
- Liquidated damages are still just damages for breach

- LADs (liquidated and ascertained damages)
- Delay Damages (terminology under the NEC for of contract)
- Delay Penalty (commonly seen in Middle East and international projects)
Applying Liquidated Damages

- What could liquidated damages attach to?
  - Late completion of the project or a defined part thereof
  - Quality breach/underperformance?
  - Failure to achieve KPIs?

- While usually seen as detrimental to the paying party...
  - Liquidating the damages gives certainty of risk
  - The damages can be controlled and kept to a commercially acceptable level
  - Controlled level and certain risk should reduce the contract price

- More detailed look at time related liquidated damages

Establishing Project Overrun

- Starting point is a clear and unambiguous obligation to complete by a specific date or within a specific time
  - No completion date, no liquidated damages
  - Inability to ascertain the completion date due to events on the project, no liquidated damages
  - Inability to alter the completion date by reason of the employers default, no liquidated damages
  - Therefore, completion is and needs to be a strict obligation not based on reasonable endeavours (a reasonable endeavours clause is likely to put time at large and leave liability to general damages)
Prevention Principle

No (relevant) extension of time mechanism

Commencement Date

Contractual Completion Date

Set "at large"

Reasonable Time

Liquidated Damages

General Damages

Establishing Project Overrun (cont.)

Specific Date / Ascertainable Amount

If the Works shall not have been substantially completed within the Time for Completion or any extended time made pursuant to Clause 14, the Contractor shall pay or allow to the Employer liquidated damages calculated at the rate or rates stated in the Appendix hereto for the period during which the Works shall so remain incomplete and the Employer may recover the amount of such liquidated damages from the Contractor. The payment or deduction of such damages shall not relieve the Contractor from his obligation to complete the Works or from any other of his obligations and liabilities under the Contract.
Establishing Project Overrun (cont.)

Prevention / Time at Large

The Contractor shall be entitled subject to Sub-Clause 20.1 [Contractor's Claims] to an extension of the Time for Completion if and to the extent that completion for the purposes of Sub-Clause 10.1 [Taking Over of the Works and Sections] is or will be delayed by any of the following causes:

(A) a Variation (unless an adjustment to the Time for Completion has been agreed under Sub-Clause 13.3 [Variation Procedure]),

(B) a cause of delay giving an entitlement to extension of time under a Sub-Clause of these Conditions, or

(C) any delay, impediment or prevention caused by or attributable to the Employer, the Employer's Personnel, or the Employer's other contractors on the Site.

Provided always that the Contractor shall not be entitled to any extension of time where the instructions, or acts of the Employer or the Superintending Officer are necessitated by or intended to cure any default of or breach of contract by the Contractor and such disentitlement shall not set the Time for Completion at large.

General issues to be aware of

- Complete Remedy
  - A time related loss may have many facets, all will generally be covered by a LD clause attaching to late completion
  - If LDs for late completion are stated as nil then there are no damages recoverable at all (Note: different position in Australia – such an intention needs to be expressed clearly and unequivocally J-Corp Pty Ltd v Mladenis)
  - Only applies to the breach which the liquidated damage attaches to
  - The actual loss suffered is irrelevant as long as the liquidated amount has been properly arrived at
Complete remedy

If the Contractor fails to comply with Sub-Clause 6.2 [Time for Completion], the Contractor shall subject to Sub-Clause 2.5 [Employer’s Claims] pay delay damages to the Employer for this default. These delay damages shall be the sum stated in the Particular Conditions, which shall be paid for every day which shall elapse between the relevant Time for Completion and the date stated in the Taking-Over Certificate. However, the total amount due under this Sub-Clause shall not exceed the maximum amount of delay damages (if any) stated in the Particular Conditions.

These delay damages shall be the only damages due from the Contractor for such default, other than in the event of termination under Sub-Clause 15.2 [Termination by Employer] prior to completion of the Works. These damages shall not relieve the Contractor from his obligation to complete the Works, or from any other duties, obligations or responsibilities which he may have under the Contract.

Payment of Late Substantial Completion Damages by Contractor shall constitute Contractor’s sole and exclusive liability and Owner’s sole and exclusive remedy for Contractor’s unexcused failure to achieve Substantial Completion by the Guaranteed Substantial Completion Date.

General issues to be aware of (cont.)

- Who makes the assessment and deduction
- Assessing delay
  - As planned impacted
  - Collapsed as-built
  - Windows
- Right not an obligation
  - Liquidated damages, generally, can be deducted but do not have to be
  - The deduction can, generally, be delayed or set aside entirely
Unenforceable if constitutes a penalty

- Four-limb test in *Dunlop Pneumatic Tyre Co v New Garage and Motor Co*:
  - Extravagant as compared to greatest loss which could be suffered from breach
  - Only breach is non-payment of money, but consequence is payment of higher sum
  - Same monetary amount or other consequence for different breaches
  - Not necessarily a penalty if difficult to difficult to pre-estimate true loss

- Test often thought to be whether LDs are “genuine pre-estimate of loss” — if not “genuine pre-estimate of loss”, must be a penalty

- Hence proliferation of contractual provisions: “*The parties agree that the liquidated damages are a genuine pre-estimate of loss …*”

  other commercial reasons may also justify the amount BUT intent for including such amount must not be to deter the breach

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**The Dunlop decision**

- **Dunlop**
  - Manufacturer
  - Sets list price at £4.10

- **A Pellant Ltd**
  - Trade purchaser
  - Dunlop’s agent

- **New Garage**
  - Retail sales
  - Sells tyre at £3.12

NG had to pay fee of £5 for selling < list price

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Savings provisions

- **Genuine pre-estimate**
  
  "For the avoidance of doubt, the Parties agree that any sums payable pursuant to this clause are a genuine pre-estimate of the loss that the Employer will suffer as a result of EPC Contractor’s failure to achieve an Actual Capacity Date on or before the relevant Target Capacity Date."

- **Amount reasonable**

  The amounts of these liquidated damages are agreed upon and fixed hereunder by the Parties because of the difficulty of ascertaining the exact amount of losses and/or costs that will be actually incurred by Owner in such event, and the Parties hereby agree that such amounts are a reasonable estimate of Owner’s probable loss (and are not a penalty) and that such amounts shall be applicable regardless of the amount of such lost revenues and increased costs actually incurred by Owner.

Savings provisions (cont.)

- **Savings provision**

  "If the obligation to pay Late Substantial Completion Damages is found for any reason to be void, invalid or otherwise inoperative so as to disentitle Owner from claiming such damages, Owner shall be entitled to claim against Contractor for damages at law resulting from Contractor’s failure to achieve Substantial Completion by the Guaranteed Substantial Completion Date, provided that Owner shall not be entitled to recover any such damages at law in excess of the limitation on Contractor’s liability for Late Substantial Completion Damages under Subclause 18.1."
The new rule in England and Wales

- **ParkingEye Limited v Beavis and Cavendish Square Holding BV v Talal El Makdessi** [2015] UKSC 67

- New test: “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”

- Supreme Court decision has revised the rule on penalties
  - confirmed that it is a long standing principle of English law; not removed it altogether or extended it
  - confirmed existing law that it applies not only to payments but to obligations to transfer assets for nil / undervalue
  - emphasized the importance of commercial justification
  - a penalty provision is unenforceable (not able to be scaled down)
The new rule in England and Wales (cont.)

Question 1: when does penalty rule potentially come into play?
- Provisions operating on breach of contract
- Courts do not otherwise regulate fairness of contracts
- Note: this is a matter of substance, not form

Question 2: is the provision a penalty?
- “out of all proportion” to the legitimate interest in the enforcement of the obligation
- “extravagant, exorbitant or unconscionable”

Judgment can be found at https://www.supremecourt.uk/cases/uksc-2015-0116.html both in text and video

ParkingEye v Beavis

ParkingEye manages a retail car park for British Airways pension fund
ParkingEye’s revenue is the GBP85 overstay charges it imposes on users who park for more than 2 hours

Beavis parks his car
Does not dispute that there are sufficient signs to inform him of overstay charges
Stays for more than 2 hours
Refuses to pay a fine

ParkingEye brings a claim to recover the money
Beavis resists the claim on basis that it is a penalty

OVERSTAY CHARGE WAS A SECONDARY OBLIGATION
BUT NOT PENAL – IT HAD A LEGITIMATE COMMERCIAL BASIS
Cavendish v El Makdessi

Parties enter into SPA

• If Makdessi breaches the non-compete clause
  - Makdessi will not be entitled to interim and final payments
  - Cavendish would have an option to buy Makdessi’s holdings at NAV value

El Makdessi breaches the contract

• Initial payment was made
• Makdessi breaches non-compete clause

Cavendish exercises its rights

• Cavendish withholds payment and seeks specific performance of the right to buy Makdessi’s shares at NAV (no goodwill)
• Makdessi resists

• PRICE ADJUSTMENT MECHANISM IS A PRIMARY OBLIGATION (SPLIT)
• CAVENDISH HAD A LEGITIMATE INTEREST IN ENFORCING NON-COMPETE

New test: When is the provision penal?

Is it a primary or secondary obligation?

Primary

No

Secondary

Is the detriment on the contract breaker out of all proportion to the legitimate interest of the other party?

Not

Penal

Unenforceable

Yes

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New test: Primary v. Secondary Obligations

- Penalty doctrine only applies to **secondary obligations** that arise out of a breach of contract.

**Stansfield Business International Pte Ltd v Vithya Sri Sumathis** [1998] 3 SLR (R) 927
  - Plaintiff school commenced proceedings against student for failing to pay outstanding school fees when she terminated her course prematurely.
  - Contract provided that she had to pay full fees even if she chose not to complete the course for the academic year.
  - Held: penalty rule was not operative as the school’s claim was for the contract sum (i.e. a primary obligation) and not damages payable upon a breach of the contract (secondary obligation).

- The test for a primary obligation: “Can the penalty rule be applied without making a new contract for the parties?”

New test: Legitimate interest

- Lord Neuberger and Lord Sumption:
  "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”

- Straightforward damages case:
  - the innocent party’s interest is in compensation
  - apply traditional test of is it a genuine pre-estimate of loss

- The innocent party may have other legitimate interests in the performance of the defaulter’s obligations beyond compensation → **commercial justification**

- Is the provision out of all proportion as compared to that interest?
Observations

- Courts will be slower to find provisions are a penalty given the recognition that commercial parties are the best judge of whether a provision is justified.

- Challenges to liquidated damages clauses are less likely to succeed → there is the potential to look at a wider justification for their inclusion.

- Note: even if the provision is a penalty, the innocent party is still entitled to ordinary damages.
Position in Australia: going in a different direction

- **Andrews v ANZ Banking Group Ltd** [2012] HCA 30
  - does not distinguish between primary and secondary obligations
  - applies to collateral stipulations that are in the “nature of security for and in terrorem of the satisfaction of the primary stipulation”
  - applies whether or not the collateral stipulation arises on breach or on the happening of an event → wider application

- Case remitted to determine if the bank fees were penalties

Position in Australia (cont.)

- High Court did not offer further guidance on how to determine when a provision will be penal; **Dunlop** test still applies

- Focus on determining what was a genuine pre-estimate of loss for the innocent party

- What about commercial justification?
  - Full Federal Court in **Paciocco v ANZ Banking Group Ltd** highlighted that the genuine pre-estimate of loss test may be too strict or too vague
  - Instead the Full Federal Court said the real consideration should be whether the pre-agreed amount is “extravagant”, “unconscionable” or “oppressive”
  - **IPN Medical Centres Pty Ltd v Van Houten** – could take other commercial interests such as goodwill, IP into account not just loss of services
  - High Court decision pending in **Paciocco v ANZ Banking Group Ltd**
Observations

- UK and Australia differences
  - *Dunlop* will still apply to most liquidated damages clauses in the same way
  - Australia – a wider range of fees / charges / clauses could be considered penalties
  - UK – more willing to look at wider business interests
Position in Singapore: Dunlop

- *iTronic Holdings Pte Ltd v Tan Swee Leon and another suit*, [2016] 3 SLR 663; [2016] SGHC 77 cited Cavendish Square (albeit in obiter)
  - penalty rule applies only to the consequences arising from breaches of primary obligations and not to the primary obligations themselves
  - “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”

- BUT Dunlop principles still apply: is the sum extravagant or unconscionable in comparison with the greatest loss
  - *Xia Zhengyuan v Geng Changqing* [2015] SGCA 22
  - Cited Lord Dunedin’s speech

Position in Singapore: Dunlop (cont.)

- Test of commercial justification does not apply
  - *Pun Serge v Joy Head Investments* [2010] SGHC 182
  - *Hong Leong Finance v Tan Gin Huay* [1999] 1 SLR(R) 755: Default interest was a penalty (6.25% → 18%)

- Only applies when payable upon breach of contract
  - *Stansfield Business International Pte Ltd v Vithya Sri Sumathis* [1998] SGHC 423

- Can apply to a transfer of property
Position in Hong Kong: Dunlop

  - did not take opportunity to consider *Cavendish*
  - Dunlop principles still apply
  - Hon Barma JA: “there is much to be said for the first proposition stated by Lord Dunedin in Dunlop – that a clause will be held to be a penalty where the amount stipulated for is extravagant compared with the greatest loss that could be proved to flow from the breach.”

- *Leung Wan Kee Shipyard Ltd v. Dragon Pearl Night Club Restaurant Ltd and Another* [2015] HKCFI 2225
  - Court of First Instance considered *Cavendish Square* but in relation to relief from forfeiture

Position in the PRC: Civil Law

- Parties may agree an amount or method for calculating an amount based on the circumstances of a breach of contract
- If petitioned by the parties, a court or arbitration institution may increase the amount if the agreed amount is lower than losses incurred
- Conversely, a party can petition to have the amount reduced if the agreed amount is “excessively higher than losses incurred”
  - *In accordance with the 2nd Interpretation of Contract Law of the Supreme People’s Court the amount shall qualify as “excessively higher” if the agreed amount exceeds actual losses by 30% or more*
- Breaching party is still required to perform its obligations after paying liquidated damages for delayed performance
Section 5
Considerations post-Cavendish

What is a “legitimate business interest” in the construction sector?

- Cannot look at “construction” as one sector
  - Public
    - Transport
    - Government
  - Private
    - Housing
    - Utilities
  - PPP
  - Social (health and education)
  - Infrastructure (roads)

"The parties hereby accept and understand that the liquidated sum protects the legitimate business interests of [ ] and that the sum is a reasonable one in all the circumstances".
Forget what you can do… what do you want to achieve?

- Remember the purpose of the project in the first place, that purpose was NOT the recovery of damages for late delivery.
- Purpose of a liquidated damages provision
  - Compensate the party who has performed
  - Incentivise (albeit it negatively) performance
  - Act as a deterrent
- The liquidated damages should not get in the way of performance
- Proper consideration to how and why the project is running late BEFORE the completion date is missed

Alternatives to Liquidated Damages

- Incentivised early completion
- Structured delay damages
  - Changing rates for changing periods
  - Capped delay damages
- Sectional damages only
- Focus on performance against KPIs not just time
- Liquidated damages insurance
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Bree has worked in Asia for 10 years and prior to that trained with a top tier firm in Australia. She has particular expertise in project delivery method selection and risk allocation, drafting, reviewing and negotiating procurement arrangements (including EPC contracts) as well as the full suite of project documentation including concession and offtake agreements, consortium agreements/JVAs, supply agreements and services contracts.

Bree has advised on projects in Australia, the PRC, Hong Kong, Macau, Singapore, Indonesia, the Philippines, Thailand, Vietnam, Pakistan, South Korea, the UAE, Qatar, South Africa, Cameroon, Mozambique, Azerbaijan and the UK, among other countries.

Her experience includes advising:

- Alstom Transport on a secondment basis as acting Head of Legal East Asia
- EDF in relation to an energy efficiency project in the PRC
- Mitsubishi Corporation and TEPCO on their bid for, and development and financing of the 2,400MW/130MIGD Facility D independent water and power project in Qatar
- an international developer on its proposed investment into and development of a wind farm in the Philippines
- the lenders (including Barclays, DBSA and an ECA) on the project documents and procurement arrangements for the project financing of Mainstream Renewable Power’s development of wind and PV solar power projects across the South African Renewable IPP Procurement Programme Rounds
- AES Corporation on its development of a 216MW gas fired power project and associated transmission infrastructure in Cameroon, Africa financed by IFC, ADB, FMO, PROPARCO, BDEAC and EIB
- ONGC Videsh on the EPC contracts for LNG liquefaction facilities and export facilities on its acquisition of US$ multi-billion stakes in gas fields and associated facilities in East Africa.
- CLP’s subsidiary on its development of a 1320MW power station in Haryana, India
- SunEdison and NextEnergy on the negotiation of EPC and O&M contracts for the development of portfolios of solar projects in the United Kingdom supported under the Renewables Obligation scheme
- the Abu Dhabi Sewerage Services Company (ADSSC) on its standard form contract and negotiation of the design, construction, financing and handover of sewerage infrastructure assets by private developers in Abu Dhabi
Amanda Lees
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Amanda specialises in cross border dispute resolution through international arbitration and complex multi-forum litigation. She has experience acting in international arbitrations in Asia and Australia and related stay, anti-suit and anti-arbitration applications. Amanda also sits as an arbitrator.

Amanda is a Fellow of the Chartered Institute of Arbitrators and Singapore Institute of Arbitrators and Director of the Chartered Institute of Arbitrators Singapore Branch.

Amanda is also adept at using alternative dispute resolution, such as mediation and expert determination.

She has acted in commercial disputes in Asia and Australia across a range of business and industry sectors, including energy and resources, construction, banking and finance, insurance and reinsurance, telecommunications, manufacturing and consumer goods industries.

Amanda has substantial experience of drafting and advising on dispute resolution provisions in complex projects and construction contracts, including arbitration provisions, ICSID clauses, sovereign immunity clauses, jurisdiction clauses and expert determination clauses.

She recently acted as a counsel in an arbitration on the forfeiture of an interest in an oil field, arguing that the provision was a penalty.

Her other recent experience includes:

- acting as arbitrator and counsel in multiple commodity sales disputes, involving arbitrations and proceedings in multiple jurisdictions
- acting as counsel in a dispute over a telecommunications infrastructure agreement in SE Asia
- acting for an EPC contractor in a dispute over a right of first refusal
- acting for an Indonesian miner in a dispute with its mining services contractor
- acting for an Australian mining company in a dispute with its Indonesian joint venture partner over its interest in a large resources deposit in Indonesia
- acting in a large litigated construction dispute over 5 years against a multinational builder /developer
- acting for a multinational chemicals company in an UNCITRAL arbitration in Singapore concerning a licence agreement for an Indian petrochemicals plant with related court litigation in India

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