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CDI Lawyers Update

Construction, Development & Infrastructure

Liquidated Damages or a Penalty?

When a party (usually the contractor) fails to complete works on time there is often a clause to award the injured party Liquidated Damages (**LDs**) as compensation for delay. Two judgements in Australia and the UK have reinforced the need to keep detailed records of how LDs are calculated: in the first case a developer succeeded in being awarded LDs after a court affirmed the contractual right to "perfect completion", whilst in another case a subcontractor failed after it neglected to consider the potential consequences of a contract amendment.

What is a Penalty?

In Australia, principles of *Dunlop Penumatic Tyre Co Ltd v New Garage and Motor Co Ltd* [1915] AC 79 are applied when deciding whether a LD clause is to be categorised as a penalty. The courts will consider whether the payment stipulated was not a "genuine pre-estimate of the loss" and if the amount was "extravagant and unconscionable" in comparison with the greatest loss that could have been suffered from the breach. These questions are to be assessed relative to the time of the contract being made, and require the whole of the contract to be examined in the circumstances (this is discussed further in the case of *Unaoil* below).

Grocon Constructors (Qld) v Juniper Developer: "perfect" completion in the contract

In *Grocon Constructors (Qld) Pty Ltd* (**the Contractor**) *v Juniper Developer No. 2 Pty Ltd & Anor* (**the Developer**) [2015] QSC 102, the court was asked to rule on whether a clause in the contract, which imposed LDs for delay in reaching practical completion, was void on the ground that it imposed a penalty.

The Contract

Under the contract, the Contractor was required to reach practical completion by a date set in the contract. The definition of practical completion itself was exhaustive, in effect a "shopping list" of items to be completed by the Contractor. This included both the usual matters, and other (as was argued by the Contractor) "minor matters", such as the non-operation of a single kitchen appliance and small areas of the works not being professionally cleaned.

The contract further imposed a LDs clause on the Contractor for delay in reaching practical completion by the date for practical completion. The amount of LDs was scheduled and charged, for example in one portion of the contract, as follows:

(a) 1-8 weeks after the date for practical completion - $12,250 per day;

(b) 9-16 weeks - $24,500 per day; and

(c) 17 weeks on - $49,000 per day.

The kicker in the Contract was that failure to reach practical completion by the date for practical completion, *in any respect*, would bring the LDs clause into effect.

Arguments and Decision

The Contractor submitted that because the LDs clause imposed as a lump sum per day, if the delay was due to a trivial defect, the rate imposed would be "extravagantly" out of proportion to the loss suffered, and out of proportion to the damages that would have been suffered by the Developer.

In his judgement, Lyons J disagreed and found that the penalty doctrine did not apply where LDs were lump sums for one or more events of varying degrees of damage. As was noted by Lyons J, failure to achieve practical completion may cause serious loss to the Developer and therefore the LDs were not out of proportion to the anticipated losses. His Honour concluded that the LDs clause was a genuine pre-estimate of the damages likely to be suffered by the Developer if

there was a delay in reaching practical completion.

Unaoil v Leighton Offshore: Subsequent contract amendments

In *Unaoil Ltd* (**the Subcontractor**) v *Leighton Offshore PTE Ltd* (**the Contractor**) [2014] EWHC 2965, the Subcontractor claimed against the Contractor for breaching a memorandum of agreement (**MOA**) which had appointed the Subcontractor for onshore construction works on a substantial oil infrastructure project in Iraq.

The first MOA was worth US$75m, and included a clause entitling the Subcontractor to LDs of US$40m if the Contractor breached the MOA. However, in order to increase the chances of securing the work at competitive tender, the parties signed a supplementary agreement. This amended MOA changed the pricing mechanism for the subcontract works which reduced the lump sum price from US$75m to a minimum price of US$55m. The LDs clause, however, remained unchanged.

Arguments and Decision

The Contractor argued that the LDs was a penalty. The High Court of England and Wales found that LDs of $US40m "was or at least may have been a genuine pre-estimate of the loss" when the original contract price was US$75m and therefore not originally a penalty. Once the second MOA reduced the contract to $55m, however, the LDs could no longer be a genuine pre-estimate of likely loss. As the Subcontractor could not produce documents to commercially justify the clause, US$40 million was deemed extravagant and unconscionable and therefore an unenforceable penalty. In doing so, Eder J made a determination that the validity of the LD clause was not at the time that the MOA was entered into, but when the MOA was amended and in effect expanded the principle stated in *Dunlop*.

What this means for you

The *Grocon* decision provides more certainty on how the penalty doctrine applies to construction contracts, particularly where the definition of practical completion is exhaustive. The decision is not supportive of the concept of "perfect completion".

The primary issue in the *Unaoil* decision was that the Subcontractor did not consider the potential consequences of amendments to the MOA. Parties need to pay close attention when negotiating changes to a contract and consider whether it affects how a LD clause is triggered or the calculation of LDs. By neglecting to fully review its impact on the contract, the subcontractor in *Unaoil* did not appreciate that the LD provision was no longer appropriate and had exposed them to risk.

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