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Struck Down: When Liquidated Damages Become Unenforceable

November 10, 2014

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Construction law can be something of a dark art "“ there isn't a day that goes by where the humble construction lawyer isn't presented with a bit of a head-scratcher. Take liquidated damages, for example. It's clear that an LDs provision shouldn't seek to penalise the offending party. It's also clear that LDs should represent a "˜genuine pre-estimate' of the innocent party's loss following breach. So until recently, the well-advised client would make a reasonable effort to assess the likely losses as a result of a particular breach, describe them clearly in the contract and keep records showing the parties' working. And they could rest safe in the knowledge that any court applying English law would be very reluctant to interfere with a commercial agreement on LDs. Yet a series of recent cases has given lawyers and their clients food for thought. In two cases, LDs provisions were held to be unenforceable and struck down. So are the courts are seeking to adopt a more flexible approach to LDs, reflecting the commercial reality of their use in commercial contracts? Or do these cases indicate a move towards the approach seen in certain civil law and Middle Eastern jurisdictions, where the courts have the power to revise a commercial agreement on LDs? Such a shift would threaten LDs' very purpose of providing certainty of recourse and exposure and avoiding expensive arguments over actual losses further down the line. The traditional approach It's worth a recap of liquidated damages in English law. An LDs clause provides for payment of a pre-determined sum in the event of the breach of a particular contractual obligation. In construction contracts, the obligation is typically a requirement to complete by a certain date, with LDs compensating loss caused by the delay. In energy projects, LDs are also commonly used in support of an obligation to achieve a certain level of performance. However, LDs can be used in relation to any type of contractual obligation. LDs can't be used as a threat for breach because, under English law, parties are free to breach their contractual obligations on payment of damages. A penalty clause seeks to impose a higher measure of damages which constitutes a "˜blatant interference with freedom of contract'. Instead, the level of LDs should be a "˜genuine pre-estimate' of the loss which would be suffered by the innocent party. Until recently, it was considered that assessment of the level of LDs was to be judged at the time of making the contract, rather than at the time of breach. These principles forced the courts to adopt a binary approach to LDs: either the level was a genuine pre-estimate (and therefore enforceable) or it wasn't (and therefore struck down). But what if, for example, it wasn't possible to make a sensible pre-estimate of potential losses at the date of the contract? In complex energy projects, there could be any number of

factors beyond the fact of the delay which would determine the extent of any losses. Commercial justification It is in this context that the court in El Makdessi vs Cavendish Square Holdings BV & Anor [2013] EWCA Civ 1539 considered an LDs provision relating to a share sale. The relevant clause stated that in the event that the seller, Makdessi, breached certain covenants, he would receive nothing for shares already transferred and a significantly reduced price for the remaining shares. To determine whether the clause was penal, the court considered whether the relevant clauses were "˜extravagant and unreasonable' (they were) and commercially justifiable (they weren't). One of the key factors in the decision was that Makdessi would be hit with the same level of LDs whether for a trivial or a substantial breach. The case was a rare example of an LDs provision being struck down and gained a good deal of coverage at the time. But when the dust settled, it became clear that parties still couldn't go far wrong as long as they made a genuine effort to calculate the likely losses. Indeed, this approach was supported by the decision in Bluewater Energy Services BV vs Mercon Steel Structures BV & Ors [2014] EWHC 2132 (TCC). In that case, the subcontractor, Mercon, was liable for LDs of â‚¬150,000 following replacement of key personnel. Mercon argued that the level of LDs was intended as a penalty for replacing key staff and didn't accurately reflect the resultant losses. The court allowed the LDs. Whilst acknowledging the difficulty of quantifying the loss in this scenario, the court held that the damages were not unconscionable, extravagant or exorbitant. Contract amendments Whilst the Makdessi and Bluewater cases may not have precipitated a sea-change in approach to liquidated damages in the construction industry, the recent case of Unaoil vs Leighton [2014] EWHC 2965 (Comm) may do just that. Leighton and Unaoil entered into a Memorandum of Agreement relating to the construction of an oil pipeline in Iraq. They agreed that Leighton would go into bat for a tender to construct the pipeline and, if successful, would appoint Unaoil as a subcontractor. The agreed subcontract price was $75 million, with LDs of $40 million payable to Unaoil in the event that Leighton breached the MOA. The subcontract price was subsequently reduced to $55 million but, crucially, the level of LDs remained the same. Leighton won the tender but didn't go on to appoint Unaoil (on the grounds that Unaoil was not acceptable to Leighton's employer). Unaoil claimed for the full LDs amount. In a departure from previous cases, the judge held that the levels of LDs should be assessed at the date of amendment of the MOA and not at the date of the original contract. The LDs of $40 million, when measured against the revised price of $55 million, were deemed to be "˜extravagant and unconscionable, with a predominant function of deterrence' and "˜without any other commercial justification'. The LDs provision was struck down. Other jurisdictions compared The recent line of caselaw raises an interesting question as to whether English law is moving closer to the approach adopted in certain civil law or Middle Eastern jurisdictions such as Qatar and the UAE. In those jurisdictions, a party is able to challenge a contractually agreed level of LDs on the grounds that the level of compensation doesn't match the actual losses. This means that a contractor can apply for a reduction in LDs where the actual loss suffered is lower, or even ask for them to be set aside where the employer hasn't suffered a loss. Equally, an employer may apply for higher LDs if justified by the actual losses. This is particularly concerning for contractors, for whom the key advantage of LDs is protection from the vagaries of general damages. Well, we're certainly not there yet. Both the Makdessi and Unaoil cases will provide hope to contractors who face being walloped with substantial LDs

mounting up on a daily basis and we expect to see other LDs cases brought as a consequence. But the courts have shown every willingness to abide by a commercially agreed level of LDs. Indeed the use of "˜extravagant', "˜unreasonable', "˜unconscionable', "˜exorbitant' and "˜without any other commercial justification' indicates that an LD figure would have to be wildly wide of the mark to be in danger of being struck down. On that basis, we will still advise our clients to make every effort to establish likely losses, describe them clearly in the contract and keep contemporary records of the underlying calculations. However, given the economic climate and the recent developments in caselaw, the prudent client may also seek to adopt additional measures to safeguard the enforceability of the LDs. These may involve taking greater care to evaluate LDs, not only during contractual negotiations, but also throughout the course of a project, to assess whether any contractual amendments might have an appreciable impact on likely losses necessitating an adjustment to the level of LDs.