

Liquidated Damages - Some General Principles

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Liquidated damages are always an emotive topic for both contractors and employers alike. This is particularly the case in Hong Kong where in recent years the size and importance of projects has meant that huge sums of liquidated damages per day are included in the contract in the event of late completion by the contractor. Quite often these sums are of such magnitude that a two-month delay could threaten the very livelihood of many local contracting organisations.

But this is nothing new. Leading textbooks describe the case of *Fletcher v Dyche* where a contractor (a Mr Fletcher) entered into a contract (with a Mr Dyche) to carry out repairs to a church. The contract period was six weeks and the contract provided that should he fail to complete within this period liquidated damages of per week would be applied until completion. Completion was delayed for four weeks and Mr Dyche applied liquidated damages at the agreed sum. Mr Fletcher argued that the wording of the damages clause showed that the sum of was a penalty and not liquidated damages and that the clause was therefore invalid, and that if the employer was entitled to any damage it must be general damages that he could prove to have suffered. A familiar story which could have come from any contract that most of you are working upon. However this case was decided in 1878.

One hundred and twenty three years later contractors are still arguing such points and we seem to have progressed no further.

In light of this it seemed appropriate to set down a few general principles about liquidated damages in order to dispel a few myths and provide a better understanding to avoid unnecessary dispute.

Firstly, a few points about damages in general. Damages are the remedy for breach of contract. They are normally assessed when breach occurs, and are designed to be compensatory in nature. Two principles important for assessment of damages are the principles of remoteness derived from the famous case of *Hadley v Baxendale* (1854) in which Baron Alderson said: -

"Where two parties have made a contract which one of them has broken, the damages which the other party ought to receive in respect of such breach of contract should be such as may fairly and reasonably be considered either arising naturally, i.e. according to the usual course of things, from such breach of contract itself, or such as may reasonably be supposed to have been in the contemplation of both parties, at the time they made the contract, as the probable result of the breach of it"

and measure of damages derived from the equally old case of *Robinson v Harman* (1848) where it was stated:

"The rule of common law is that where a party sustains a loss by reason of a breach of contract, he is, so far as money can do it, to be placed in the same situation, with respect to damages, as if the contract had been performed".

Damages calculated from these principles are normally assessed after the breach occurs and are known as general or unliquidated damages. However, there are disadvantages of such an approach. Firstly, they are difficult to assess, and secondly, parties to a contract like certainty.

This led parties to include within their contracts remedies for most common breaches. This was particularly so in

construction contracts where breaches are very commonplace, particularly in the areas of delay to completion. For the employer, however, the most common breach suffered is late completion by the contractor and here it is possible to make a genuine pre-estimate of the loss and to incorporate the same into the contract as liquidated damages. This is how liquidated damages developed - good commercial practice.

The important features of liquidated damages can be summarized as follows:

- **Liquidated damages are a genuine covenanted pre-estimate of loss not a payment of money 'in terrorem' (threatening) the offending party.**

This was established in *Dunlop Tyre v New Garage* (1915) where Lord Dunedin set out the following guidelines:

- (a) It will be held to be a penalty if the sum stipulated is extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have followed from the breach
- (b) It will be held to be a penalty if the breach consists only in not paying a sum of money, and the sum stipulated is a sum greater than the sum, which ought to have been paid.
- (c) There is a presumption (but no more) that it is a penalty when a single 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 damages.
- (d) It is no obstacle to the sum stipulated being a genuine pre-estimate of damage that the consequences of the breach are such as to make precise pre-estimation almost impossibility. On the contrary, that is just the situation when it is probable the pre-estimated damage was the true bargain between the parties.

- **Liquidated damages can be recovered without proof of loss and they can therefore also be recovered even when it is apparent there has been no loss.**

Provided that the liquidated damages are a genuine pre-estimate of loss at the time the contract is entered into, the employer is entitled to take such damages if the contractor is late in completing the works even if it is subsequently shown that the employer in fact suffers either less or indeed no loss. This was confirmed in the case of **Clydebank Eng & Shipping Co v Castaneda** where the courts threw out the shipbuilders ingenious argument that the Spanish Government suffered no loss in the late delivery of the warships because had they been delivered on time they would all have been sunk by the American Navy in a battle that had occurred during the delay.

- **A party can challenge the validity of a liquidated damages sum after the contract has been signed**

Whilst in the case of **Philips v Attorney General of Hong Kong**, the court emphasizes that the fact that the parties were able to agree beforehand the damages recoverable for a breach of contract was to the advantage of both parties since they should be able to estimate with a reasonable degree of certainty the extent of their liability and the risks which they run, it is nonetheless clear that the parties to a contract can challenge terms, if for example, they are contrary to the law either in Statute - Control of Exemption Clauses Ordinance or in this case at common law where for example liquidated damages are a penalty.

- **The Employer can take liquidated damages even if the architect or the**

engineer fails to grant a timely extension of time.

Most forms of contract set down very rigid time limits for the contractor to serve notice of a claim for an extension of time but few are so strict on the time within which the contract administrator must act. A question often asked is if the contract administrator does not grant an extension of time in a timely manner does this invalidate the liquidated damages provisions. The answer to this, much to the contractor's disappointment, appears to be no. In the case of *Temloc v Errill Properties* (a case concerning the JCT form of contract) the court said:

"In my view, even if the provision of clause 25.3.3 [requirement for the architect to review extension of time within 12 weeks of practical completion]

is applicable, it is directory only as to time and is not something which would invalidate the calculation and payment of liquidated damages. The whole right of recovery of liquidated damages under clause 24 does not depend on whether the architect, over whom the contractor has no control, has given his certificate by the stipulated day".

In all of the above considerations it must be remembered that liquidated damages, whilst an emotive topic, are often to the benefit of both parties in giving certainty of liability and risk to a contract. This is particularly important for construction contracts.

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