A LEGAL COMMENTARY ON THE POSITION OF LIQUIDATED ASCERTAINED DAMAGES IN THE UNITED KINGDOM

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ABSTRACT
The purpose of this paper is to consider the various aspects of a liquidated agreed damages clause (LAD) in contracts, from the perspective of recent English case-laws in the United Kingdom. The focus is on the law on penalty generally in terms of its principles and criteria that are needed for a clause to be a valid LAD clause, the rationale for parties to agree to such a LAD clause and the effects of a LAD clause in a contract. The definition, use and implication of exclusion clauses and limitation clauses are also considered. The purpose of this paper is moreover to focus the mind of contracting parties on the legal considerations as to the nature and effect of such clauses. Better understanding of the legal implications of such clauses would place the parties in a better position to negotiate and protect their own interests. Recommendations and safeguards are suggested for the benefit of the contracting parties.

INTRODUCTION.

When parties enter into a contract there are rights and obligations which are vested upon the parties. Breach of contract means that the party (hereinafter referred to as the defaulting party) to a contract does not fulfill an obligation under the contract. Upon the breach or non fulfillment of an obligation by the defaulting party the innocent party has always the remedy of damages.[1] To recover damages however, the innocent party has to sue for breach of contract and has the evidentiary burden to adduce proof under the principle of law as set out under Hadley v Baxendale (1854) 9 Exch341.[2]

However if the parties agree at the time of contract that a certain sum of money is payable in the event of breach of a particular obligation under contract, the said sum is termed as a liquidated agreed damages clause (LAD). The LAD is based on a genuine pre-estimate of the loss, assessed at the time of contract, which would arise as a result of the breach of contract and quantified at a certain sum payable in event of the breach.

The said sum may be set off[3] against monies due to the defaulting party without having to sue for breach of contract. In the event there are no monies due to the defaulting party, the innocent party may sue for recovery of the LAD without having to discharge the evidentiary burden of proof of loss. However the said LAD clause may be challenged by the defaulting party as a penalty and may be treated as invalid if it is found to be a penalty. This paper intends to include discussion on:

1. The definition of LAD clauses, limitation of liability clauses and exclusive remedy clauses.
2. The rationale and effect of agreeing to a LAD clause with reference to presumptions created and the evidentiary burden of proof.
3. Charting the development of the test or criteria applied by the courts in deciding whether the LAD is a valid LAD or a penalty.

DEFINITION AND TYPES OF LAD CLAUSES.

A liquidated ascertained damages clause (LAD) is a clause in a contract that fixes an agreed amount or an amount to be derived from an agreed formula to be paid by the defaulting party in the event of a breach. The liquidated ascertained damages may include those damages that flow naturally and directly as a result of the breach of contract and also consequential damages that do not flow directly from the breach of contract but were within the reasonable contemplation of the

parties at the time of contract. Two examples of LAD clauses are as follows:

1.Delay Liquidated Damages (DLD).
The purpose of DLD is to compensate for loss and damage suffered as a result of late completion of the contract. Usually DLD are calculated based on the extra charge per day of delay which in turn is based on the extra cost and loss incurred[4]as a result of the project not being completed on time.

2. Performance Liquidated Damages (PLD).
The purpose of liquidated damages here is to compensate for underperformance of the plant or facilities contracted for. The relevant performance guarantee may be with regard to efficiency, output, performance specification or availability.[5]

DEFINITION AND EFFECT OF AN EXCLUSIVE REMEDY CLAUSE.
Another question that warrants consideration is whether a LAD clause is drafted as an exclusive remedy clause. An exclusive remedy clause is one where the parties agree to make the remedy stated under the contract as the only remedy available to the parties. The parties cannot sue for or pursue a remedy other than that stated in the contract.

In Decoma UK Limited v Haden Drysys International Ltd [2005] EHWC B12, Decoma made a claim for damages in excess of 18 million pounds for breach of contract arising from defects in the paint-spraying system designed, built and installed by Haden for Decoma facility. The contract between parties was a negotiated contract and the contract price was for 8,738.799 million pounds. In response to the claim by Decoma for damages, Haden relied on the contract terms which, in varying ways, limit or exclude their liability for damages. On the facts of the case, due to the breaches of contract by Haden, substantial completion as defined in the contract was never achieved and as result there had never been Final Acceptance of Haden paint-spraying system. The issue of the LAD clause being an exclusive remedy clause and the effect of a limitation clause both arose for the court's consideration.

Haden relied upon Article 12.3 which concerned Liquidated and Ascertained Damages. The said clause can be found on page 12 of the judgment of Judge Peter Coulson QC on para 39,

"Article 12.3 was the provision concerned with Liquidated and Ascertained Damages. Such damages were payable if Haden failed to achieve the Final Completion Date and ascended on a rising scale to a maximum amount of 5% of the Contract Price'. The deduction and payment of the liquidated damages were said to be: '...In full satisfaction and accord of the Contractor's liability to achieve Final Acceptance by the Final Completion Date. Both parties are agreed that the aforementioned rates are a genuine pre-estimate of loss." (Emphasis added).

The learned judge also on page 14 considered Article 12.4 which was titled 'Limitation of Liability' which was divided in four parts, wherein the second part reads,

"Further, damages for any breach of this Agreement by the Contractor prior to Final Acceptance Certification, shall expressly not exceed, in aggregate to any payments that shall become payable under Article 12.3, the maximum amount of 5 % of the Contract Price...and such liability or payment shall be in full satisfaction and accord of the Contractor's liability for the said failure..."

The fourth part found in this same page further states that:
"Any exclusion or limitation of liability under this Agreement shall exclude or limit such liability in contract, tort, or otherwise."

Should Haden's contention be correct, Decoma's entitlement would most likely be limited to 5% of the contract price. The learned judge considered arguments on these legal questions as preliminary questions and found merits in Haden's arguments.

It was sought to be argued that Decoma could have a claim for losses suffered prior to Final Acceptance that was not covered by the LAD

clause. On construction of the agreement, the court held that the LAD clause was an exclusionary remedy for claims prior to Final Acceptance.

In his judgment, Judge Peter Coulson on page 18, inferred the intent of the parties as wanting to restrict damages claimable to LAD for claims prior to Final Acceptance. The court held that the LAD clause was, under the terms of the contract, drafted as an exclusive remedy clause for claims suffered prior to Final Acceptance.

"Article 12.3
For the reasons which I have already identified, I am satisfied that, prior to Final Acceptance, Decoma's claims would principally have been for liquidated damages pursuant to the express terms of Article 12.3, arising from Haden's breach of the Final Completion Guarantee at Article 12.2. This entitlement was an exclusive remedy for all claims arising out of Decoma's inability to use, and make a profit out of, the paint-spraying system due to Haden's delay in completing it to the required standard. (Emphasis added)

I should add that I do not accept the argument that this entitlement could somehow only be ascertained after Final Acceptance: there is nothing in Article 12.3 that supports such an unusual interpretation. It follows, therefore, that there could be no separate entitlement on the part of Decoma, prior to Final Acceptance, to make a claim for lost profit and the like as a result of being deprived of their use of the paint-spraying system, in addition to their right to liquidated damages. The liquidated damages would be Decoma's sole remedy in such a situation." (Emphasis added).

Hence, even though the Final Acceptance was not achieved, the LAD clause with the limitation of liability and the exclusive remedy clauses stood to bind Decoma and prevented them from making a claim under alternative heads of claim of loss of profit and the loss of use of the paint spraying system.

In cases where there is no exclusive remedy clause, arguably in law, the innocent party should be able to claim for any damages that they have suffered as a result of the defaulting party breach or default which is not covered under the LAD provision. It would be prudent in any event to express such intention in the terms of contract if this is the case.

DEFINITION AND EFFECT OF LIMITATION OF LIABILITY CLAUSE.

Apart from an exclusive remedy clause, there is a limitation of liability clause usually found in construction contracts. The validity of such a clause is not dependent on the question of reasonableness of the liability limited. It is treated as an agreed term that sets a cap on losses that may be recoverable from the breach of contract. In such cases, the court gives effect to the intention of parties and the quantum of any form of damages, be it liquidated or unliquidated, to be awarded is within the perimeters of the limitation of liability clause and not in excess of it even if the losses are proved as exceeding the set limit.

It is the general presumption of law that any limitation or deprivation of right to other remedies available to the parties must be clear, in order to be effective.

On page 6 of the Decoma case, the court held that,

"Exclusion clauses, and for these purposes I include the kind of cap clauses referred to above, have been the subject of much comment by the courts in recent years. The general principle is summarised at paragraph 12.19 of The Interpretation of Contracts:
Clear words are necessary before the court will hold that a contract has taken away rights or remedies which one of the parties to it would have had at common law." (Emphasis added).

In the case of Temloc Ltd v Erril Properties (1987) 39 BLR 30, the damages for non -completion under clause 24 referred to an appendix where in the relevant section the word 'nil' was inserted. The court held that on the proper construction of the contract, the parties had agreed that there was to be no damages of any sort payable, whether as LAD or under any general damages for delayed completion,[6] as the defaulting party's liability had been limited to "nil".

The court in Decoma case cited earlier on page 6, highlighted that where the limitation clause is clear and effective the wrongdoer could rely on it to cap or limit his liability, as this is the intent and purpose of such a clause,

"A number of the relevant provisions appear to provide that Decoma can recover for a particular type of loss against Haden, but only up to a certain specified financial limit. Such "cap" clauses, which are a common feature of commercial contracts, reflect an agreement between the parties that, in the event of a breach, the wrong-doer's liability will be fixed at a pre-set maximum level. In one sense, of course, the wrong-doer who seeks to rely on such a clause is seeking to take advantage of his own wrong, because the cap clause in question can only be triggered by his breach of contract in the first place.

It would, however, be absurd to suggest that, if the cap clause was clear, the wrong-doer could not rely on such a provision to limit his liability, because that is exactly what the parties have agreed that he can do. Accordingly, what will be of the utmost importance in this case is the overall scheme of the Contract and the wording of the particular clauses themselves, and whether they do, clearly and unambiguously, cap Haden's liability for particular claims in the way for which they contend." (Emphasis added).

His Honour Judge Peter Coulson commented that a limitation clause has commercial implication and is in nature of allocation of risk and liability between the parties on paragraph 59 of page 19 of his judgment,

"In these circumstances, if there were problems (and therefore delays) in the proper completion of the paint-spraying system, Decoma's position would have been protected by the express terms of the Contract set out above. Of course, the delays might have been so extensive that Decoma's claims for loss of profit/ loss of use were greater than the liquidated damages capped at a maximum of 5% of the Contract Price. However, that possibility was plainly in the contemplation of the parties at the time that they agreed to the terms of Article 12.3: indeed, it is inevitable that, where any contractual claim is capped by agreement, circumstances might arise where the actual loss exceeds the cap. I agree with Mr. Taverner QC's submission that this cap was simply part of the general allocation of commercial risk between the parties." (Emphasis added).

Ultimately the limitation clause serves as a cap and excludes recovery of damages beyond the amount stated or limited by the clause. This applies irrespective as to whether the amount is a LAD amount or otherwise an amount recoverable as general damages (unascertained amount) under the law.

THE ADVANTAGES OF A LAD CLAUSE.
The advantages are as follows:

1. Certainty.
The contracting parties are aware from the beginning as to the extent of liability that may be incurred by them upon breach of a specific term.[7]

2. Avoidance of evidentiary burden.
The non defaulting party will have an advantageous position in that he may recover the liquidated sum without the difficulty and expenses of proving actual damage.[8] The provision allows for efficient recovery of compensation and negates or reduces legal costs or the raising of legal questions as to whether a specific loss is recoverable under the question of remoteness of damages.[9] As stated earlier the LAD may be set off against the sum due to the defaulting party's acts/omission arising out of the same transaction without the innocent party having to file a legal suit.

3. Amicable settlement and avoidance of disputes[10] and legal costs.
The probability of being compensated is likely when the amount is a pre-agreed amount. It is

meant to preserve the relationship between the parties even when a party is in breach as it was a pre-agreed consequence. It also reinforces contractual obligations and serves as an added deterrent against breach. As stated earlier, the sum due as LAD may be designed under the contract to be deducted from monies due and owing to the defaulting party. This negates the need to file a legal suit for breach of contract to recover damages.

4. Allocation and Distribution of Risk. [11]
The parties, knowing in advance the liabilities in the event of breach, are better able to allocate and distribute the associated risk and loss. They are better able to take the necessary precautions in terms of insurance or negotiating terms in other related contracts. It may also result in a modification of contract prices as the parties are enabled to factor in cost of risk and liability management. The party who has to meet the obligations in order to avoid LAD may decide to take out a LAD insurance in the event of inability to fulfill those obligations.[12]

EFFECT OF A LAD PROVISION.

1. In cases where the liquidated damages clause is a valid clause, it is implicit that both parties are bound by the agreement.[13]
2. A non-defaulting party cannot later complain that his actual loss is more and seek to recover the greater loss.[14]
3. Similarly, the defaulting party cannot argue that the actual loss is less than the liquidated damages to avoid paying under the liquidated damage clause if it was a reasonable estimate based on possible ranges of losses assessed at the time of the contract.[15]
4. The burden of proving that a LAD clause is a penalty is on the party seeking to avoid the clause.[16]
5. The non-defaulting party has the advantage in that he need not prove his actual loss in order to recover damages if the LAD clause is enforceable.[17]

PRE-AGREED DAMAGES - LIQUIDATED DAMAGES OR A PENALTY? REVIEW OF CASE LAW DEVELOPMENT.

The law on damages for breach of contract is clear in that the non-defaulting party is not to be enriched by the defaulting party's breach but to be compensated for loss that arises as a result of the breach. Hence an amount randomly fixed as a LAD with no association to the nature of loss expected at the time of contract where the intent is just to deter breach of contract is treated as a penalty.

When a sum of money has been pre-agreed as the damages payable in event of breach of an obligation, the question that arises is whether the said sum is to be treated as liquidated damages (LAD) or a penalty. If it is a LAD, then the innocent party can recover irrespective of his actual losses. Whereas if it is a penalty, then he may recover only so much that will compensate for the actual losses.

STATUTORY LAD – NOT A PENALTY.

A statutory LAD is one where the LAD is not commercially negotiated between the parties. The parties instead contract upon a standard form that is required under a statute wherein that form provides for a LAD clause that is fixed by statute.

An example of such a contract is found in the Privy Council case of Golden Bay Realty Pte Ltd vs Orchard Twelve Investment Pte Ltd [1991] 1 SLR 18. The case concerned a sale and purchase agreement entered under the statutory form prescribed by the Sale of Commercial Properties Rules 1979 passed by the Minister under the powers vested in him under Sale of Commercial Properties Act 1979. The contract entered into was a statutory contract. There was a statutory LAD provision where in the event of failure to give notice to complete on the completion date, the LAD clause provided that the developer shall pay damages at the rate of 9% pa on a sum equivalent to 85% if the purchase price .

A statutory LAD, it would seem, is not to be subject to the law of penalty, in that there is a presumption that the LAD is NOT a penalty. This is the ratio in the Privy Council case of Golden Bay Realty Pte Ltd vs Orchard Twelve Investments

Pte Ltd. Here, the parties entered into a statutory standard-form contract with a LAD provision.

On the argument that the LAD is not a genuine pre-estimate, the Privy Council, in a judgment rendered by Lord Oliver on page 22, supported the Court of Appeal decision of Thean J:

" It cannot be said that the legislature intended by the rules to enact or prescribe a form of agreement which contains, inter alia, provisions which may be penal in nature. It must be taken that the legislature in providing for liquidated damages has considered various factors and adopted the formula as set out in cl 14(2) as a genuine pre estimate of damages."

Lord Oliver quoted the passage with approval on page 23, as:

"There is simply no room for an argument that the form which, acting intra vires, the minister had prescribed is unconscionable and void."

NON STATUTORY LAD – THE TEST AND CRITERIA APPLICABLE.

On non-statutory LAD, we shall look at the development of case law in order to ascertain the test and criteria developed to assess whether a pre-agreed sum is a valid and enforceable liquidated damage clause or a penalty.

The case of Dunlop Pneumatic Tyre Co Ltd v New Garage & Motor Co Ltd [1915] AC 79 deserves mention as no article on LAD would be complete without it. The case concerned a provision whereby the dealer received certain trade discounts and *"agreed not to tamper with the marks on the goods, not to sell or offer the goods to any private customer or any cooperative society at less than the appellant's list prices, not to supply to persons to whom the manufacturer would not supply and to pay a sum of 5 pounds by way of liquidated damages for every tire, cover or to be sold or offered in breach of the agreement".*

The dealer sold a tyre cover to a cooperative society below the current list price and the manufacturer sought damages. The dealer argued that the clause was a penalty and hence unenforceable. The Court of Appeal held that since the LAD provision provided for damages to be paid for breaches of varying degrees of importance, the relevant provision had to be treated as a penalty. The House of Lords took the view that such a clause did not necessarily need to be a penalty.

Lord Dunedin's passage in judgment from pages 86 to 88 is quoted below:

"I shall content myself with stating succinctly the various propositions which I think are deductible from the decisions which rank as authoritative:-

1. *Though the parties to a contract who use the words "penalty " or "liquidated damages " may prima facie be supposed to mean what they say, yet 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 said to be found passim in nearly every case.*
2. *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 and Shipbuilding Co v Don Jose Ramos Yzquierdo y Castaneda [1905] AC 6).*
3. *The question whether a sum is a 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 making the contract, not as at the time of the breach.*
4. *To assist this task of construction various tests have been suggested, which if applicable to the case under consideration may be helpful, or even conclusive. Such are:*

(a) *It will be held to be a 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.*

(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 that ought to have been paid (Kemble V Farren (1829) 6 Bing 141).This though one of the most ancient instances is truly a corollary to the last test ....

(c) There is a presumption (but no more) that it is a penalty when 'single lump sum is made payable by way of compensation, on the occurrence of one or more or all of the several events, some of which may occasion serious and others but trifling damage.'

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 are such as to make precise pre-estimation almost impossibility. On the contrary that is just the situation when it is probable that the pre-estimated damage was the true bargain between the parties ...".

In the case itself, Lord Dunedin found the principle he set out under (d) as applicable and the presumption set out in (c) as inapplicable. So it does not follow that if any of the criteria mentioned is applicable it is in itself decisive that a LAD clause is to be declared a penalty. The criteria are considerations to be applied but not conclusive test in itself in determining the validity of a LAD clause.

His Lordship stated in his finding on page 88 that the principles under item (d) applies, "*But though damage as a whole from such a practice would be certain, yet damage from any one sale would be impossible to forecast. It is just, therefore one of those cases where it seems reasonable for parties to contract that they should estimate damage at a certain figure and provided that the figure is not extravagant there would seem no reason to suspect that it is not truly a bargain to assess damages, rather a penalty to be held in terrorem...*".

On the other hand in relation to presumption (c), the penalty of five pounds being a single sum stipulated as payable for the occurrence of multiple events did not negate its enforceability as a valid LAD in the case of Dunlop. On facts of case however, Dunlop's action failed on grounds of privity of contract.

In Clydebank Engineering and Shipbuilding Co v Don Jose Ramos Yzquierdo y Castaneda [1905] AC 6, the court was concerned with a contract for the construction by a Scottish shipbuilder of four torpedo boats for the Spanish Government where the penalty for late delivery was at the rate of 500 pounds per week for each vessel.

Lord Halsbury LC on page 11 of the Clydebank case found that the sum was not a penalty, saying it was,

"obvious on the face of the contract that the very thing intended to be provided against by this pactional amount of damages is to avoid [the] kind of minute and somewhat difficult and complex system of examination that would be necessary if you were to attempt to prove the damage."

Both the cases of Dunlop and Clydebank dealt with situations where the damages were difficult to ascertain and hence the legitimacy of the recourse to a LAD clause which was found to be defensible and valid. The rationale of these cases rests on the difficulty of the assessment of the damages and the difficulty of proving damage which renders the LAD provision valid.

There is wide usage of LAD clauses in commercially negotiated contracts. The contracting parties use the LAD clause in a commercial sense having impact on contract pricing, insurance, allocations of risk and responsibilities and in contract administration planning. Hence the courts are more conservative when called upon to determine a pre-agreed sum payable as a penalty upon breach of contract.

In the case of Phillips Hong Kong Ltd V AG of Hong Kong (1993) 61 BLR 41, the Privy Council applied a more practical approach in the construction of liquidated damages clauses. Lord Woolf rejected the argument that a liquidated damages clause is penal in nature if it can be argued that in case of certain hypothetical breaches, the agreed sum is greater than the actual loss.

The court moved away from interpreting Lord Dunedin's guidelines too literally in cases of commercial contracts where the LAD clause is linked to allocation of risk management that has commercial value to the contracting parties. The paramount consideration is focused upon the strength of the parties' bargaining powers.

This is evident in Lord Woolf's judgment on page 58,
"Except possibly in the case where one of the parties 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 objectionably 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...".

His Lordship went on to make the point on page 59 that *"likewise the fact that two parties who should be well capable of protecting their respective commercial interest agreed that the allegedly penal provision suggests that the formula for calculating liquidated damages is unlikely to be oppressive ...".*

Hence there is an inference in commercially negotiated contracts that the LAD provision is a prima facie non-penal clause. The case is also an authority for the proposition that the estimated losses need not be correct. Lord Woolf, in giving support to this proposition on page 59 where it is stated that:
"Even in such situations, so long as the sum payable in the event of non compliance with the contract is not extravagant, having regard to the range of losses that it could reasonably be anticipated it would have to cover at the time of contract was made, it can still be a genuine pre – estimate of that loss that would be suffered and so a perfectly valid liquidated damage provision."

Lord Woolf also commented on page 59,
"the fact that the issue has to be determined objectively, judged at the date of contract was made, does not mean what actually happens subsequently is irrelevant." In the case his Lordship found that Philips was not *"suggesting in these proceedings that the sum claimed is excessive in relation to the actual loss suffered by the Government."*

In the High Court case of Alfred McApline Captial Projects Ltd v Tilebox Ltd [2005] EWHC 281(TCC), Jackson J had the opportunity to consider the law on liquidated damages. But since this case was decided before Murray v Leisureplay Plc [2005] EWCA Civ 963, the benefit of the Court of Appeal's rationale in Murray was not considered.

The facts of Alfred McApline are as follows. Tilebox purchased a substantial commercial property with the intention of stripping and refurbishing it. Tilebox was to be paid development completion fee and a management fee. On completion of its funding arrangement, Tilebox entered into contract with McAlpine and negotiated a LAD clause stating that 45000 pounds to be paid by McAlpine per week in event of delay. The completion date was extended to 14 August 2002.

By the time of trial, it was understood that the work would not be completed until at least the summer of 2005. The effect would be the amount of LAD would be around 5.5 million pounds. The contract sum was 11,573,076 million pounds. McAlpine applied for a declaration that the LAD clause was unenforceable as a penalty.

The Court accepted Tilebox's argument that the rate of damages was a reasonable pre-estimate of damages at time of contract having structured it around the loss it would receive under the development completion payment and its potential liability to its funder for damages. Jackson J, after consideration of the four factors below, decided that the LAD was reasonable and conservative pre-estimate of damages having assessed the foreseeable losses on reduction in completion payment and that Tilebox had a liability to its funder for losses arising from the delay.

Jackson J conceded that the weekly foreseeable losses would have been less if he was wrong on this point but that did not change the position. The pre-estimate was reasonable taking into account the reduction in the development

payment. Further, the pre-estimate did not become a penalty simply because it exceeded the actual loss suffered.

Jackson J's four general observations as on page 9 read as follow:

1. *"There seems to be two strands in the authorities. In some cases judges consider whether there is an unconscionable or extravagant disproportion between the damages stipulated in the contract and the true amount of damages likely to be suffered. In other cases the court considers whether the level of damage was reasonable. Mr Darling submits and I accept, that these two strands can be reconciled. In my view, a pre-estimate of damages does not have to be right in order to be reasonable. There must be a substantial discrepancy between the level of damages stipulated in the contract and the level of damages which is likely to be suffered before it can be said that the agreed pre-estimate is unreasonable.*
2. *Although many authorities use or echo the phrase "genuine pre-estimate," the test does not turn upon the genuineness or the honesty of the party or parties who made the pre-estimate. The test is primarily an objective one, even though the court has some regard to the thought processes of the parties at the time of contracting.*
3. *Because the rule about penalties is an anomaly within the law of contract, the court is predisposed, where possible, to uphold contractual terms which fix the level of damages for breach. This predisposition is even stronger in the case of commercial contracts freely entered into between parties of comparable bargaining power.*
4. *Looking at the bundle of authorities provided in this case, I note only four cases where the relevant clause has been struck down as a penalty. These are Commissioner of Public Works v Hills [1906] AC368, Bridge v Campbell Discount Co Limited [1962] AC 600, Workers Trust and Merchant Bank Limited v Dojap Investment Limited [1993]AC 573 and Ariston SRL v Charly Records (Court of Appeal 13th March 1990). In each of these four cases there was, in fact a very wide gulf between (a) the level of damages likely to be suffered and (b) the level of damages stipulated in the contract."*

The gist is that the court will prima facie, uphold a commercially negotiated LAD clause especially where there is equality in bargaining power. In determining whether the pre-estimate is genuine, the honesty of the party who made the estimate is not the decisive factor. The court will look to the difference between the pre-estimate LAD and the actual loss suffered to assess if the amount is reasonable as a LAD. The difference needs to be substantial to warrant inference by the court in considering whether it is to be treated as a penalty.

The question of LAD also received some fresh considerations in the case of Murray v Leisureplay Plc [2005] EWCA Civ 963. The case concerned an employment contract. One of the issues was the validity of the clause providing for payment of a year's gross salary in the event of termination of Mr Murray's appointment without the requisite one year's notice, i.e., whether the clause was unenforceable as a penalty. The court was satisfied that the contract was a negotiated contract without any unfair bargaining power applied.

In the case of Murray v Leisureplay Plc [2005] EWCA Civ 963 on pages 10, 26 and 28 respectively, all the three Court of Appeal Justices were in favour of recasting the question from whether a payment was stipulated in "terrorem" of the offending party under item 2 in Lord Dunedin's passage (cited above) to the question posed by the judgment of Colman J in Lordsvale Finance plc v Bank of Zambia [1996] QB 752 at 762G of the case,

"Whether a provision is to be treated as a penalty is a matter of construction to be resolved by asking whether at the time the contract was entered into the predominant contractual function of the provision was to deter a party from breaking the contract or to compensate the innocent party for breach."

Colman J continued in holding the following:
"That the contractual function is deterrent rather than compensatory can be deduced by comparing the amount that would be payable on breach with the loss that might be sustained if the breach occurred."

Lady Justice Arden on page 13 paragraph 54, after consideration of previous case laws on liquidated damages, summarized the questions that needed to be asked as follows:

i) *"To what breaches of contract does the contractual damages provision apply?*
ii) *What amount is payable on breach under that clause in the parties' agreement?*
iii) *What amount would be payable if a claim for damages for breach of contract was brought under common law?*
iv) *What were the parties' reasons for agreeing to the relevant clause?*
v) *Has the party who seeks to establish that the clause is a penalty shown that the amount payable under the clause was imposed in terrorem, or that it does not constitute a genuine pre-estimate of loss for the purposes of the Dunlop case, and, if he has shown the latter, is there some other reason which justifies the discrepancy between i) and ii) above ?"*

The contribution of Her Ladyship's judgment to the law on LAD, is the recognition that the discrepancy between the LAD and the actual loss may be explained or justified by other commercial non-monetary considerations.

Interestingly, Her Ladyship on page 17 para 76 considered the disadvantages accruing to the parties without a pre-determined damages clause in the event of wrongful termination where,

"I have taken into account the disadvantages to it of wrongful termination without a pre-determined damages clause. I do not consider that the court is precluded from taking such matters into account. To do so is consistent with freedom of contract, which the doctrine of penalties has so far possible to respect. Such consideration may help to explain why a party may wish to take on an obligation (without that explanation) might be considered to be sufficiently onerous to be a penalty within paragraph a) of Lord Dunedin guidance. Such considerations may indeed be best described as the justification for the said clause to be a penalty, rather than elements of genuine pre-estimate of the damage. In my formulation of the steps above, I do not intend to exclude such considerations or the possibility that a clause could be justified on this sort of ground alone." (Emphasis added).

Her Ladyship also made the following statement in her judgment on page 13,

"I agree with Mr Bannister that the parties do not have to make an accurate assessment of the damages that would have been awarded at common law."

Lord Justice Clarke held in his judgment on page 26 that the LAD was not a penalty on the following basis.

First,
"Given the general principle of pacta sunt servanda, the court should be cautious in before holding that a clause in the contract of this kind is a penalty."

His Lordship's other considerations as paraphrased is that in order to decide whether an amount is a penalty, it is necessary to ask whether, in asserting the LAD, the predominant function at the time of contract is to deter the party from breaching the contract or to compensate for breach. A particular clause might be commercially justifiable provided that its dominant purpose is not to deter the other party from breach. The circumstances the court should consider would include the importance of both parties knowing the financial consequences of the breach and of avoiding disputes. A clause would be held as a penalty only if the sum payable on breach is extravagant or unconscionable. The burden of showing that the sum is a penalty is on the party resisting the application of the clause.

His Lordship said on page 27, *"It is in my opinion important to avoid nice calculations but to look at the question in the round. It was not for Mr Murray to justify the clause but for the respondent to show that it was a penalty ".*

Lord Justice Buxton too decided that the LAD was not penal. In his judgment on page 29, he commented that,

"An exclusive concentration on the factual difference between the liquidated and the contractual damages overlooks a principle test formulated by Lord Dunedin to identify a penalty, [1915] AC at p87, that "It will be held to be a 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 ...".

Lord Justice Buxton commented that the LAD may be a generous amount and in excess of the pre-estimated contractual damages but that in itself does not make the LAD a penalty. On the same page Lord Justice Buxton said,

"That such reassurance exceeds the likely amount of contractual damages on the dismissal does not render the terms penal unless the party seeking to avoid the terms can demonstrate that they meet the test of extravagance posited by Lord Dunedin and by Lord Woolf. I regard that as a comparatively broad and simple question that will not normally call for detailed analysis of the contractual background." (Emphasis added).

The final word evident in the tone of the judgement of the Court of Appeal generally reflects that in a commercially negotiated contract the courts will be slow to assume that a LAD clause is a penalty just from the fact that such a clause could result in greater recovery than the actual loss.

This is found on page 30 of the judgment made with reference to the Dunlop case,

" But the cautious approach of the House, and its willingness to look at the clause in its commercial context, does at least underline the importance stressed by Lord Woolf of not moving automatically from the fact that a clause could result in greater recovery than the amount of the actual loss to an assumption that without further justification the clause must be penal in nature."

SUMMARY OF THE ABOVE CASES.

1. In a contract, especially one shown to be commercially negotiated, there is an inference that the LAD clause is valid. The courts will be slow in interfering with the commercial bargain entered by the parties.
2. The person seeking to avoid the application of the clause bears the burden to show otherwise. This is a heavy burden.
3. The clause needs only to be a reasonable estimate of the probable loss (as opposed to actual loss) flowing from the breach. The estimate need not be right or accurate. The court looks at the round figure rather than requiring a detailed justification of the LAD amount.
4. The fact that there is a difficulty in pre-estimating the loss does not mean that the LAD is invalid or that it is a penalty. This may be the very reason for a LAD sum to be pre-agreed upon.
5. A liquidated damages clause will be unenforceable as a penalty if the pre-agreed sum is considered as an unreasonable estimate of the probable loss or where it has been used by one party to impose pressure or to oppress the other party (which in turn will lead to an unreasonable pre-agreed sum). Here, the extravagant or unconscionable element of the LAD amount should be shown, which will also in turn show that the intent is to deter breach of contract, rather than to compensate.
6. The comparison between the LAD amount and the amount of common law damages claimable acts as an indicator of the reasonableness of the estimated loss. The court needs to be satisfied, in event of a wide discrepancy, that it is justified as a genuine pre- estimate of damages or by some other form of justification.

7. The court will look at a LAD clause and determine its pre-dominant function at time of contract. If it was to compensate rather than to deter a breach of contract, then it is considered a valid LAD. This is the modern approach of Lord Dunedin's test that "the *essence of a penalty is a payment stipulated as in terrorem of the offending party.*"
8. In construing the LAD clause, the court will consider surrounding circumstances, commercial intent of the parties and commercial justification of the clause, in order to rationalize whether the LAD was intended as a deterrent to breach of contract and hence a penalty, or otherwise a commercially negotiated provision with other commercial benefits conferred on the parties. This would make the provision a genuine pre-estimate of loss and not a penalty, despite the fact that common law damages would be less than the LAD.
9. The discrepancy between the common law damages and the LAD amount needs to be shown to be extravagant or unconscionable, and not merely generous, in order for the LAD amount to be considered a penalty. In the Murray case, Lord Justice Buxton considered the LAD clause to be generous, but held that on its own, the clause is not sufficient to make it a penalty. It has to be shown that the amount is extravagant or unconscionable.
10. It would seem a statutory LAD would be held to be a valid LAD clause and virtually, cannot be challenged as a penalty.

RECOMMENDATIONS TO CONTRACTING PARTIES.

1. The innocent party needs to record and keep in his custody, data to evidence that the LAD provision in the commercial contract was a negotiated provision. This is in the event that the parties who contracted on the other standard form contracts wish to adduce any evidence to indicate that the parties were not in equal position or bargaining power. All evidence should be documented. The fact that the LAD clause was open to discussion and negotiation would be a positive factor.
2. The basis of assessment indicating how the pre-estimate sum is reached should be laid down. It is in the best interest of the innocent party to set a rate that is defensible. Setting an amount that is too high and not linked to a basis of assessment can invalidate the clause as a penalty as well as discouraging other contractors from bidding, thereby leaving the owner with a higher contract price and a clause which the courts will not enforce. Under the law, the onus lies with the defaulting party to show the sum is excessive.

In cases of construction contracts, for example, a prudent owner will keep some form of calculation in its files, showing how it arrived at the daily rate (estimated extra architect /engineer fees, additional rent or storage fees, additional machinery / labour fees, and financing charges). Extra insurance and losses suffered (revenue forgone) are some considerations. It is also prudent to bear in mind Lord Dunedin's presumption that a single sum is a penalty if it is payable on multiple breaches. This presumption separates a penalty from a LAD provision in that a lower rate is set for loss of use of incomplete items after substantial completion for construction contracts.

Further, an owner who wants to take partial occupancy may provide for a reduced LAD rate for the rest of the work. There is also a distinction for delay liquidated damages and performance liquidated damages and the different types of performance liquidated damages. It is recommended that separate DLD and PLD for distinctive contract performance obligations be provided as the basis of assessment is different. In cases of construction contracts especially, there are procedures that need to be adhered to in order to place reliance on a LAD clause.

In the case of Bell and Son (Paddington)Ltd v CBF Residential Care and Housing Association (1989) 46 BLR 102, the employer lost his right to deduct or claim liquidated damages, as the non-completion certificate, which was a condition precedent to claim for liquidated damages, was not issued. The case demonstrates the need to

comply with procedural requirements set out especially in standard form construction contracts prior to raising or invoking a claim for liquidated damages.

3. Any commercial benefit given or obtained by virtue of agreeing to the LAD clause. This would make the court more inclined to interpret the clause as one that is intended to deter a breach to one that is meant to compensate for the breach and part of the commercial bargain of the parties that the court will seek to uphold. Such as projection or estimation of projected losses or projected liabilities is utilized to compute the pre-agreed sum as LAD. This may also include practical benefits that may be within the consideration of the parties that lead to the acceptance of the LAD clause that need to be recorded.
4. Any recorded data to indicate that discrepancy between the actual loss that could conceivably be proven to flow from the breach and the LAD sum is not too extravagant and unconscionable as distinct as simply being a generous pre estimate of loss. No need for a detailed analysis but a reflection of an estimation exercise in determining the LAD to show that the intent is not to deter breach. Commercially too this works out to the advantage of the innocent party as a reasonable contract price is reached. This is good practice despite the fact the burden is on the defaulting party to show that the LAD is extravagant or unconscionable.
5. The insertion of clauses whether a LAD clause, a limitation clause or an exclusive remedies clause should properly reflect the commercial bargain and the intention of the parties, who should be advised as to the nature, effect and implication of such clauses when agreeing to the same as insight has been provided under Decoma case discussed above.

COMMENTATOR'S CONCLUSION

The contracting parties should be aware that once a LAD clause is agreed upon the parties are bound by it and the defaulting party has a difficult burden in attempting to evade the clause. Likewise the innocent party remedies are limited to the amount pre-agreed as the LAD under the contract. Hence the factors discussed above will serve to create an awareness of the parties as to the legal and commercial implication of a LAD clause in their contracts.

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APPENDIX

1. The innocent party has the right to terminate or affirm the contract if the term breached is a condition and not a warranty in addition to a claim for damages.
2. The rule under Hadley v Baxendale places the onus of proof to show loss on the party seeking to recover it. The rule allows for recovery of damages that arose from the natural consequences of the breach of the contract or if it not within the natural consequences then if it flowed from facts made known and within the contemplation of the parties at the time of contract.
3. It is the norm to provide in contracts that the LAD amount is set off against any monies payable to the defaulting party and there may be some mechanisms that need to be fulfilled.
4. An estimate of additional costs incurred per day of delay would include supervision costs, machinery costs, labour costs, financing and insurance costs and losses would include loss of revenue or income.
5. Performance liquidated damages are usually a net present value (NPV) calculation of the

revenue forgone over the design life of the project. For example if a plant produces 50 tons of oil per month less than its performance guarantee and the lifespan of the plant is 25 years. Then the loss is to compensate for the loss of the underproduction of 50 tons over the lifespan of the plant. Note always that the different types of performance guarantee may require a separate PLD set.

6. An American case of Ministry Prabhuda Manji Eng Pvt Ltd v Raytheon Engineers & Contractors Inc 213 F Supp 2d 20 (US DC MASS 2002), the project owner sued the engineer for failure of the plant to achieve commercial production . The contract contained a LAD, limitation clause and a waiver of consequential damages clause. The court of this jurisdiction held that in commercial settings a limitation of damage clause will rarely be found to be unconscionable in the absence of oppression and unfair surprise. Further that a liquidated damages clause, limitation clause capping the engineer liability at 10% of its fees and waiver of consequential damages waiving "special, indirect, incidental or consequential damages of any kind "is effective to limit the damages against the design builder by the owner.
7. Robophone v Facilities v Blank [1966] 1 WLR 1428, per Lord Diplock at page 1447.
8. In the case of Kemble v Farren (1829) 6 Bing 141, at page 148,Tindal CJ in a dictum approved in the Dunlop case said that even where damages accruing from a breach of contract can be accurately ascertained, a liquidated damage clause "saves the expense and the difficulty of bringing witnesses to that point."
9. Also applied in quantifying the "loss "which is likely to be occasioned by the breach, it is the actual loss which is the relevant sum so that it is no objection that part of the loss would have been irrecoverable on the ground that it was too remote as in case of Robophone Facilities Ltd v Blank [1966] 1 WLR 1428, 1447. But then again remoteness and speculation are not in the same category. In the case Australian case of State of Tasmania v Leighton Contractors Pty Ltd (No 3) [2004] TASSC 132, the court held that LAD provision as penal and unenforceable based on its finding that the pre estimate cost in computation the sum was "extremely high, extravagant and speculative." LAD may include consequential damages that are defensible but not speculative, extravagant amounts.
10. In the case of Murray v Leisureplay [2005] EWCA Civ 963, Lord Justice Clarke on page 27 said *"it was in both parties interest to know the position and to avoid the dispute in future"*.
11. The Court of Appeal in Murray v Leisureplay Plc [2005] EWCA Civ 963, recognised the need to see commercial reality of the contract to assess how these consideration as opposed to intention to deter a party from breach may make the clause as enforceable as a LAD clause despite the fact that contractual damages arising from the breach may be much less than the LAD stipulated. Lady Justice Arden, on page 17 said "I have taken into account the disadvantages to it of wrongful termination without a predetermined damages clause. I do not consider that the court is precluded from taking such matters into account .....Such considerations may help explain why a party may wish to take on an obligation which (without that explanation) might be sufficiently onerous to be a penalty within paragraph (a) of Lord Dunedin's guidance. Such considerations may indeed be best described as justification for the said clause to be a penalty, rather than elements of a genuine pre-estimate of the damage."
12. See article by Coleman & Large Ltd for the consideration for insurability at http;// www.cj-coleman.co.uk/key/liquidated.asp.
13. See Lord Clarke's comments on the general principle of pacta sunt servanda in Murray v Leisureplay Plc [2005] EWCA Civ 963 page 26 of 30.

14. Cellulose Acetate Silk Company Ltd v Widnes Foundry (1925) Ltd 1933 AC 20 HL where the court held that despite the fact the actual loss suffered was 5850 pounds the liability of the defaulting party was limited to 20 pounds per week per the LAD for the 30 weeks delay.
15. Phillip v AG of Hong Kong (1993) 61 BLR 41, "normally insufficient to establish that a provision is objectionably penal to identify situations when the application of the provision could result in a larger sum being recovered by the injured party than his actual loss."
16. Murray v Leisureplay Plc [2005] EWCA Civ 963 per Lady Arden, "The burden of showing that a clause for the payment on breach is a penalty clause is on the party who seeks to escape liability under it, not on the party who seeks to enforce it." In Malaysia the evidentiary burden and the law of penalty has special application and consideration under Section 75 of the Contracts Act.
17. Refer to footnote 5 above.

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