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## CONSTRUCTION

### Inside:

A ruling in Tasmania will make it increasingly difficult for public sector entities to claim substantial liquidated damages in the event of a contract over run

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## Liquidated damages or penalty?

The Tasmanian Supreme Court recently considered whether a liquidated damages provision in a project deed between the state government and a construction company was in fact a penalty. Senior Associate Nick Rudge and Articled Clerk Sebastian Rudkin look at this important ruling and its ramifications.

### Background

In June 1999 the State of Tasmania and Leighton Contractors Pty Ltd (**Leighton**) entered into a project deed for Leighton to design, construct and maintain (for 10 years) 13.65 kilometres of new highway to be incorporated into the Bass Highway comprising of two sections called the Westbury Bypass and the Hagley Bypass.

When construction was not completed by the stipulated date, and according to the liquidated damages provisions of the project deed, Leighton paid \$1,832,000 to the Tasmanian Government. When this and other matters became the subject of litigation, the court had to consider whether the sum stipulated in the provision was a legitimate liquidated damage or a penalty. The court found the sum to be a penalty.<sup>1</sup>

### The damages provision

The issue relevant to this decision involved the validity of the liquidated damages provisions in the project deed.

Clause 11.6 of the project deed provided:

- (a) If the Date of Construction Completion has not occurred by the Date for Construction Completion, the Contractor must pay liquidated damages at the rate of \$8,000 for every day after the Date for Construction Completion until the Date of Construction Completion or this Deed is terminated, whichever is first.

1. *State of Tasmania v Leighton Contractors Pty Ltd* (No.3) [2004] TASSC 132 (16 November 2004) (Cox CJ).

(b) The amount referred to in clause 11.6(a) is a genuine pre-estimate of the Principal's damages if the Contractor does not achieve Construction Completion by the Date for Construction Completion.

(c) The amount payable under this clause 11.6 will be a debt due from the Contractor to the Principal.

## Relevant law

Referring to *Clydebank Engineering and Shipbuilding Co*,<sup>2</sup> Chief Justice Cox stated that the essence of a penalty is payment of monies stipulated as in terrorem of the offending party and that the essence of liquidated damages is a genuine covenanted pre-estimate of damage. Whether a stipulated 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 at the time of the making of the contract, not at the time of the breach.<sup>3</sup>

***In this case, Chief Justice Cox thought that the only estimate that was made for the principal's loss was the direct costs of supervising an over-run contract***

Chief Justice Cox quoted Mason and Wilson in *AMEV-UDC Finance*<sup>4</sup> where they referred to the 'landmark decisions' of *Clydebank* and *Dunlop Pneumatic Tyre Co*<sup>5</sup> and said: 'an agreed sum is a penalty if it is "extravagant, exorbitant or unconscionable"'.<sup>6</sup>

Again, quoting *AMEV-UDC Finance*<sup>6</sup>:

The test to be applied is one of degree and will depend on a number of circumstances, including (1) the degree of disproportion between the stipulated sum and the loss likely to be suffered by the plaintiff, a factor relevant to the oppressiveness of the term to

the defendant, and (2) the nature of the relationship between the contracting parties, a factor relevant to the unconscionability of the plaintiff's conduct in seeking to enforce the term.

Chief Justice Cox thought it a fair observation that in this case the nature and relationship between a state and a large corporation, such as Leighton, did not suggest any relevant imbalance in bargaining power.

## Calculating liquidated damages?

The sum of \$8,000 per day for liquidated damages was, according to the project director, calculated by having regard to the following aspects of the project:

- daily rates of the principal, principal's representative, project director and the principal's site representative (calculated on a six-day week);
- administrative aspects such as OH&S, secretarial and legal services; and
- site vehicles, site running expenses, travel and accommodation.

Chief Justice Cox referred to the annual calculations for the principal, project director and principal's representative and considered that the respective annual rates of \$360,000, \$430,000 and \$330,000, OH&S of \$2400 per week and an allowance of two hours of legal advice per day was total conjecture.

***The decision highlights the difficulty a government entity, as a principal, may have in ascertaining a liquidated damages sum that is a genuine pre-estimate of its loss.***

When it was considered that the principal's representative had a number of other projects under his scope of responsibilities, and that the other roles had been calculated on an annual basis, the charge-out rates for all other personnel whose services might be required if the contract overran were extremely high, extravagant and speculative.

The fact that the project was a public utility with no anticipation of a loss of revenue by reason of the delay is not in itself a proper reason for claiming that the State could suffer no damage other than the direct

2. *Clydebank Engineering and Shipbuilding Co v Don Jose Ramos Yzquierdo y Castaneda* [1905] AC 6.

3. *Public Works Commissioner v Hills* [1906] AC 368 and *Webster v Bosanquet* [1912] AC 394.

4. *AMEV-UDC Finance Ltd v Austin & Anor* (1986) 162 CLR 170 at 198.

5. *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd* [1915] AC 79.

6. *AMEV-UDC Finance Ltd v Austin & Anor* (1986) 162 CLR 170 at 193.



costs itemised. Chief Justice Cox quoted Cole in *Multiplex Constructions Pty v Abgarus Pty Ltd*<sup>7</sup> and stated:

Conceptually I do not think that it is correct to say that public works because they may not yield a cash flow, cannot result in damages to the state or public authority if delay in construction occurs. At least in some instances, an appropriate measure of liquidated damages is the cost of capital tied up for the period of delay. I regard it as an inadequate answer, in the case of public work, to say that if the work were delayed say six months, no damage is suffered, and no liquidated damages could be validly agreed because there was no delay in receipt of cash flow, and there was mere deferment of a planned recoupment of capital and interest costs over time.

## Decision

In this case, Chief Justice Cox thought that the only estimate that was made for the principal's loss was the direct costs of supervising an over-run contract and it was the court's view that those costs were extravagant, exorbitant and totally disproportionate to the likely actual costs anticipated to be incurred.

Chief Justice Cox also stated that, as the cost of the project was fully funded by the Commonwealth Government, the State was not exposed to either its

capital cost or the costs incurred after the date for construction completion. Chief Justice Cox took the view that the estimate of \$8,000 for each day of delay was not a genuine pre-estimate of the likely damage to the State resulting from the late opening of the bypass and, as a result, was unconscionable.

The court ordered the State to repay the sum of \$1,832,000 deducted as liquidated damages.

## Future considerations

Chief Justice Cox's decision highlights the difficulty a government entity, as a principal, may have in ascertaining a liquidated damages sum that is a genuine pre-estimate of its loss. Where the project is in fact being entirely funded by another tier of government, that problem will be magnified. If the project is not being funded from elsewhere, the cost of the capital tied up by the delay, on the current authorities would be a good place to start in ascertaining the liquidated damages sum. In relation to other expenses or costs that would be incurred as a result of the delay, such as project management services, any entity needs to be very careful to ensure its estimate is a genuine pre-estimate of the cost that would be incurred with reference to the specific project.

The decision, including the liquidated damages issue, is being appealed.

7. (1992) 33 NSWLR 504 at 518-519.

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