ARTICLE SUMMARY

THE PENALTIES DOCTRINE IN CONSTRUCTION CONTRACT

On 24 August 2016, Professor Doug Jones presented a lecture to members of the Society of Construction Law (New Zealand) on the penalties doctrine in international construction contracting.

In his address, Professor Jones discussed the status of the penalties doctrine in international construction contracting with reference to liquidated damages, common law in a variety of jurisdictions, construction contracts, policy considerations underlying current application of the penalties doctrine in New Zealand, and potential directions in which the doctrine may develop in the future.

A brief summary of Professor Jones' lecture follows. A copy of the full lecture can be accessed here.

Key Points

It is common practice for parties to include liquidated damages clauses in construction contracts due to the variable and often unpredictable nature of the construction industry. By incorporating a fixed sum payment in the event of non-compliance, parties can avoid the considerable time and expense involved in proving loss, which can be notoriously difficult in the construction sector. Such advance agreement also protects the principal's interest in timely performance (or compensation for delay), while also putting the contractor on notice to the extent of damages it will be liable for in the event of delayed completion of the contract works. However, the doctrine of penalties continues to limit parties' ability to agree to liquidated damages.

Professor Jones explores two UK authorities of particular relevance to the construction industry, *Clydebank*[1] and *Dunlop*[2], where the Courts upheld liquidated damages clauses, recognising the importance of such clauses where precise pre-estimation of loss is impossible. In their assessment, the Court in *Clydebank* asked what the nature and extent of the innocent party's interest in performance of the relevant obligation was - an approach which was further revolutionised by the UK Supreme Court in *Cavendish*[3].

The Court in *Cavendish* went beyond any 'pre-estimate of loss' as considered in *Clydebank*, and instead looked at commercial justification for the clause and balanced the liquidated damages

Summary Written by: Sarah Redding, Clerk at the Building Disputes Tribunal

INTERNATIONAL ING: WHERE TO FROM HERE?

Doug is a leading international arbitration specialist. He has acted as Arbitrator and appeared as Counsel in numerous international arbitrations. Doug is also regularly involved in ADR including mediation in project disputes.

Doug is personally recognised as one of the world's leading construction and infrastructure lawyers and has received many endorsements and accolades internationally.

His experience includes acting as Counsel and Arbitrator in major international Arbitrations, and advising on project issues worldwide.

He is also a panellist with the Building Disputes Tribunal. For more infomation on Prof. Doug Jones, click here.

Author - Professor Doug Jones, AO

clause against the legitimate interest of the party seeking to enforce it. This approach marked a broader examination of the party's interest in receiving performance, rather than a mechanical and narrow focus on possible loss. This approach is of significant use in the construction industry, given the nature of construction contracts often involves interests broader than money alone (such as community expectations, reputation and goodwill).

However, while UK Courts are able to uphold liquidated damages clauses, the Courts have no jurisdiction to adjust the amount of liquidated damages agreed on to make the sum more commercially sensible in cases where the sum is penal.

Comparatively, the Court's approach to liquidated damages, and the penalties doctrine have developed along considerably different lines in other jurisdictions such as India and Malaysia. In these countries there is no hard and fast distinction between a penalty and liquidated damages clause, or a general entitlement to receive an amount in the event of a breach. Closer to home, recent Australian authorities such as the High Court decision in *Andrews*[4] widened the scope of the penalties doctrine to potentially any contractual stipulation, rather than just breach of contract. However, Professor Jones notes that this approach has received considerable criticism for its implications on the drafting of contracts, especially performance-based contracts and contacts including contingent obligations.

CONT...

Looking next to civil law jurisdictions, where the penalties doctrine operates significantly differently from common law jurisdictions, Professor Jones points out two key differences. First, that civil law countries presume the enforceability of penalty clauses to compel performance, and second, that the most notable distinction is the Court's authority to adjust or proportion the amount agreed to as a penalty (a power which falls outside most common law jurisdictions).

In turning to consider New Zealand, Professor Jones notes that *Andrews* has created divergent lines of authority between Australia and the UK regarding the application of the penalties doctrine. Whether New Zealand will follow Australian or UK authority remains to be seen, as the High Court in *ISAC New Zealand Ltd v Managh*[5] declined to answer the question in 2013.

Following the High Court's reluctance to address the issue in New Zealand, and in exploring future considerations of the penalties doctrine, Professor Jones notes the importance of recognising freedom of contract – that it is the parties who understand their own interests better than any Court, and who are in the best position to understand, approximate and bargain for the losses a breach may cause. He suggests the Courts might take a broad approach in considering admissible evidence to show the process of *how* a liquidated damages figure was reached, and whether the clause, when properly interpreted, is a penalty in all the circumstances. Further, that our common law system could learn something from civil law counterparts, particularly the ability to adjust the agreed rate of liquidated damages in line with commercial sensibility, rather than outright rejection of the clause.

Comment

The extent and direction in which the penalties doctrine in construction contracting may develop in New Zealand remains uncertain. Professor Jones' lecture highlights how different jurisdictions have approached penalties and liquidated damages clauses, and emphasises his desire to see a broader and more commercially sensible approach to upholding liquidated damages clauses, in order to recognise the flexibility and uncertainty inherent to the construction industry.

Endnotes

1. *Clydebank Engineering and Shipping Co v Don Jose Ramos Yzquirdo y Castaneda* [1905] AC 6.
2. *Dunlop Pneumatic Tyre Co Ltd v New Garage Motor Co Ltd* [1915] AC 79.
3. *Cavendish Square Holding BV v Talal El Makdessi* [2015] UKSC 67.
4. *Andrews v Australia and New Zealand Banking Group Ltd* [2012] 247 CLR 205.
5. *ISAC New Zealand Ltd v Managh* [2013] NZHC 3242.