

Article Information

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How to draft an enforceable liquidated damages clause

As liquidated damages clauses are essential to compensate principals to construction contracts, it is important that they are drafted with proper consideration and are ultimately enforceable.

Liquidated damages clauses allow a principal to charge monies at an agreed daily or weekly rate if a contractor fails to achieve practical completion of the works by the date provided for in the contract.

Why Are Liquidated Damages Clauses Important?

These clauses are imperative to principals as they provide both:

1. an incentive for contractor's to carry out work efficiently so as to complete on time; and
2. a right for principals to claim compensation at an agreed rate for their genuine estimated loss that might be incurred as a result of late completion.

The principal does not need to show that it has suffered any loss as a result of the delay. As such, contractors also receive a benefit as the clause circumvents the need for the parties to engage in costly and time consuming litigation.[\[1\]](#)

Where a principal claims liquidated damages from a contractor, it is quite common for contractors to claim that a liquidated damages clause is a penalty, and therefore unenforceable. It is important when drafting a liquidated damages clause to limit the extent to which it might be interpreted as a penalty. This all comes down to the drafting and the underlying methodology for valuing the liquidated damages rate in the contract.

But first:

What Is A Penalty?

A clause will be construed as a penalty where the sum payable (i.e. the rate specified in the contract) is out of all proportion to the interests of the non-defaulting party.[\[2\]](#) Such interests may be of a business or financial nature.[\[3\]](#) In the context of a liquidated damages clause, the principal's interest may be, for example, that practical completion is achieved on time to allow it to use the constructed factory to produce output.

The following may assist, but do not necessarily determine, whether a clause is a penalty:

1. Where the liquidated damages payable by the contractor as a result of the delay in achieving practical completion is exceptionally high when compared to the liquidated damages that would be payable by a contractor for a delay in a similar contract.[\[4\]](#)
2. Where the liquidated damages do not compensate the principal for the delay to practicable completion because that delay is incapable of causing any financial loss.[\[5\]](#)
3. Where the liquidated damages do not protect the principal's legitimate commercial interests.[\[6\]](#)
4. Where the liquidated damages do not relate to any damage or an interest of the principal arising from a delay to completion.[\[7\]](#)
5. If there is a delay in reaching practical completion, the principal has a right under the contract to claim liquidated damages as well as to seek common law damages.[\[8\]](#)
6. Where the clause punishes the contractor, rather than compensating the principal for the delay in practical completion.[\[9\]](#)

Practical Examples

Where a liquidated damages clause constituted a penalty

Spiers Earthworks Pty Ltd v Landtec Projects Corporation Pty Ltd (No 2) [2012] WASCA 53

The principal charged the contractor liquidated damages for delayed completion under a construction contract. The Court found that the liquidated damages sum was a penalty because it did not compensate the developer for the relevant breach (ie. delay) as the delay was incapable of causing any relevant financial loss. As such, the sum was considered extravagant in comparison with the greatest loss that could potentially be suffered by reason of delay.

Where liquidated damages clauses did not constitute a penalty

Grocon Constructions (QLD) Pty Ltd v Juniper Developer (No 2) Pty Ltd [2015] QCA 291

A developer charged the contractor liquidated damages under the construction contract as a consequence of the contractor failing to achieve practical completion by the date of practical completion. The contract stated that the liquidated damages rate increased incrementally based on the length of the delay.

The Court determined that the liquidated damages clause was not a penalty. Relevantly, the Court considered that liquidated damages would not be triggered on the occurrence of minor or trivial matters, such as a defective lightbulb. Rather, liquidated damages would be triggered as a result of a failure to achieve completion, which was dependent on the failure to achieve a singular obligation – the obligation to reach practical completion by the date of practical completion.

State of Tasmania v Leighton Contractors Pty Ltd [2005] TASSC 133

A contractor to a construction contract failed to complete the works by the completion date. Therefore, the principal withheld from the contractor liquidated damages at a rate of \$8,000 per day for each day until completion.

The Court found that the liquidated damages rate did not constitute a penalty as the rate reflected a genuine pre-estimate of loss that might be incurred.

Drafting Tips

When drafting a liquidated damages clause parties should attempt to calculate a reasonable pre-estimate of the loss that may arise as a result of delayed completion. Parties should avoid stipulating liquidated damages rates which could be perceived as penalising a contractor for late completion.

For example, when assessing what is a ‘genuine pre-estimate’ one should consider whether:

1. the amount should not be greater than the loss that a party would suffer following the breach; and
2. a liquidated damages clause should be represented as a daily rate for each day of delay that is not the subject of an extension of time claim under the respective contract.

A principal should not be able to recover liquidated damages as well as claim other compensation, such as damages at common law. It is also important to note that the penalties doctrine is not limited to liquidated damages only, but may also apply in the context of termination for convenience payments or interest charges.

Therefore, caution should be taken by contracting parties when drafting or amending liquidated damages clauses, and one should seek advice as to ways to minimise the risk that a liquidated damages clause could be construed as unenforceable.

[1] SA Christensen and W D Duncan, *The Construction and Performance of Commercial Contracts* (The Federation Press, 2014) 121.

[2] *Paciocco v Australia and New Zealand Banking Group Ltd* (2016) 333 ALR 569 at [2], [29], [32].

[3] *Ibid* at [2], [29], [32].

[4] *Beil v Mansell (No. 2)* [2006] 2 Qd R 499.

[5] *Spiers Earthworks Pty Ltd v Landtec Projects Corporation Pty Ltd (No 2)* [2012] WASCA 53.

[6] *Paciocco v Australia and New Zealand Banking Group Ltd* (2016) 333 ALR 569, at 572 [2], 579 [26], 614–15 [216], 616 [222]; *Melbourne Linh Son Buddhist Society Inc v Gippsreal Ltd* [2017] VSCA 161 at [195].

[7] *Ibid* at [195].

[8] *Vivienne Westwood Limited v Conduit Street Development Limited* [2017] EWHC 350 (Ch).

[9] *Paciocco v Australia and New Zealand Banking Group Ltd* (2016) 333 ALR 569 at [158].