



## Liberty Technical Update 6 - Liquidated Damages

### The Enforcement of Liquidated Damages and Insurance Implications

Most major construction and engineering projects are usually complex, multi-party and undertaken under strict time and financial constraints. Time is usually of the essence. So, if you are involved in the engineering, procurement, construction or utilities business, to name just a few examples, you are likely to be familiar with the term "Liquidated Damages" (LD). As a matter of risk management, the inclusion of LD clauses into contracts is common and considered to be an important tool that can provide certainty to contractual rights, risks and liabilities in the event of a breach. An LD clause can be an incentive for timely performance under the contract and it can also facilitate the recovery of damages in the event of breach without the difficulty and expense of having to prove actual loss. This raises a critical question: does insurance cover your liability to pay liquidated damages? But first, are liquidated damages enforceable between contracting parties?

#### Genuine Pre-Estimate of Loss

Under common law, parties to contracts can agree on a genuine pre-estimate of damages payable by the party in breach to compensate the loss likely to be suffered by the other party in the event of a breach - such as delay in performance. An LD clause operates on this basis. Usually, the clause will stipulate an amount payable per day for each day of the delay in the completion of the contract. If the amount payable is considered to be excessive, unconscionable, unreasonable or disproportionate to the greatest loss that could conceivably be proved following a breach, it might be regarded by a court as a "penalty" in which case the clause will not be enforceable. That is not to say that the aggrieved party loses the right to seek damages at law for breach of contract altogether, it simply means that the LD clause itself cannot be enforced and the plaintiff will need to seek compensation and prove actual loss in the usual way.

To ensure enforceability, it would be useful to prepare a schedule that details how the estimated figure was reached. For instance, out-of-pocket expenses such as financing and interest during construction, the daily cost of the principal and its representatives during each day of delay, legal and other general administration costs plus costs of transfer of resources during the delay period, lost opportunity costs and loss in operating revenues due to the delay in completion, and so on, might all be taken into account.

LD clauses are often the subject of litigation because of the substantial amounts involved. For example, in late 2009 an independent power company was awarded US\$26.95 million against a construction conglomerate for delay in completion.

This arguably represents the US construction industry's largest liquidated damages award.

Similarly, in 2005, the full court of Australia's Tasmanian Supreme Court held that the State of Tasmania was entitled to withhold \$1.8 million from a contractor as liquidated damages for their delay in the completion of a project.

The courts tend to look at the intention of the contracting parties at the time of contract, the nature of the contract, its complexity, the value of the project and the bargaining strength of the parties in determining whether the amount of liquidated damages prescribed in the contract was, in the circumstances, a reasonable pre-estimate of compensation payable.

#### Insurance Implications

Is cover available under a Professional Indemnity policy for liability to pay liquidated damages? Some policies specifically exclude coverage for any liability to pay penalties (contractual or otherwise) or liquidated damages for non-completion or delay in completion of any contract. In this case, the insured has an uninsured risk.

Policies which specifically exclude liquidated damages, for example "arising out of or in any way connected with liquidated damages" have the effect of excluding an entire claim brought by a third party where only part of the claim relates to liquidated damages.

Some insurance policies (such as Liberty's new range of Construction PI policies) do not contain a specific exclusion of liability for liquidated damages but may contain a general contractual liability exclusion that excludes "liability which the insured has assumed under a contract unless such liability would have attached in the absence of such contract". Although the insured's liability under the LD clause may be a "liability assumed under contract", it is meant to be a genuine pre-estimate of damages that the insured defendant (breaching party) would have to pay its plaintiff client (other contracting party). The amount payable under the LD clause may therefore be covered under the "write-back" to the exclusion if it is considered to be a "liability that would have attached in the absence of such contract". To ascertain whether the amount payable under an LD clause is equal to the amount that the insured defendant would have been liable to pay at law in the absence of such an agreement, insurers would need to carry out extensive investigation into how that amount was calculated. If coverage is in doubt, a determination by the courts may be necessary.

For insurance, the bottom line is this. Indemnity may need to be determined on the facts of each case for policies that do not specifically exclude liability to pay liquidated damages. However, such policies are more likely to provide some liquidated damages coverage than policies that specifically exclude liability to pay liquidated damages.

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