CONSTRUCTION - INTERNATIONAL

Delay liquidated damages and performance liquidated damages: what you should know

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Introduction

Engineering, procurement and construction (EPC) contracts are the most commonly used contracts for private sector construction works on large-scale and complex infrastructure projects.(1) Under an EPC contract, the contractor is obliged to deliver a complete project (eg, facility or power station) to a client that need only to turn a key to start operating the project.

At a time when construction industry operators are mumbling about a possible upturn in activity, the terms of construction contracts – in particular, the allocation of risk between the parties – are coming into sharp focus. There is a balance to be struck between the contractor's legitimate interests in protecting its business and the client's expectation that it will have recourse to the construction team for mistakes. Where this balance sits between the parties will depend on the sector, the project and the financial climate.

Given the margins with which construction firms operate, the increasing number of claims filed and the growing influence of international organisations, one of the points often raised during construction contract negotiations is the inclusion of clauses limiting financial liability.**(2)** Liquidated damages provisions for delays and performance provide a much-needed degree of certainty for both parties, although careful drafting is essential.

Liquidated damages in EPC contracts

In EPC contracts, the benefits of a liquidated damages provision for the client are obvious: it can be certain to recover a specified sum as soon as the work completion date has been missed, without having to prove actual losses. In most cases the client will be able to deduct or offset the liquidated damages against sums owed to the contractor. Importantly, the client need not have suffered actual loss to claim liquidated damages.

However, liquidated damages can also prove advantageous to contractors. As liquidated damages will in most cases provide an exhaustive remedy for delays to completion, the contractor will have the benefit of knowing from the outset of the project exactly how much it will have to pay if it cannot complete the works by the client's deadline. The contractor will often be in a position to negotiate the rate of liquidated damages, together with a cap on liability, and allow for the risk of late completion in its bid price.**(3)** Usually, two suites of liquidated damages clauses may be included in an EPC contract: delay liquidated damages and performance liquidated damages.

Delay liquidated damages

Most EPC contracts stipulate a guaranteed completion date that is either a fixed date or a fixed period after commencement of the contract. If this date is not met, the contractor will be liable for delay liquidated damages. Delay liquidated damages are designed to compensate the client for loss and damage suffered as a result of late completion of the work. To be enforceable in most jurisdictions, delay liquidated damages must be a genuine pre-estimate of the loss or damage that the client will suffer if the work is not completed by the target completion date. The genuine pre-estimate is determined with reference to the time that the contract was entered into.

Delay liquidated damages are usually expressed as a rate per day which represents the estimated extra costs incurred (eg, extra insurance, supervision fees and financing charges) and losses suffered (eg, forgone revenue) for each day of delay. A typical delay liquidated damages clause may provide as follows:

> "*If the Contractor fails to complete the Works by the Date for Practical Completion, The Contractor shall pay to the Client the sum of $10,000 per each day of delay as Delay liquidated and agreed damages. In any event, the maximum amount of liquidated damages shall not exceed 10 % of the Contract Price.*"

Performance liquidated damages
The client's revenue will be earned by operating the facility (ie, the project at hand). Therefore, it is vital that the facility perform as required in terms of output, efficiency and reliability. Consequently, EPC contracts contain performance guarantees backed by performance liquidated damages payable by the contractor if it fails to meet these guarantees.

Performance liquidated damages must also be a genuine pre-estimate of the loss and damage that the client will suffer over the life of the project if the facility does not achieve the specified performance guarantees. As with delay liquidated damages, the genuine pre-estimate is determined with reference to the time that the contract was signed. A typical performance liquidated damages clause may provide as follows:

> "*After Date for Practical Completion, if the Works fail to operate as required in terms of output, efficiency and reliability according to the dispositions of the Contract, The Contractor shall, and where Performance Failure is a result of Contractor's default, be responsible for the Repairing and shall pay to the Client the sum of $10,000 per each day until the Repairing Completion as Performance liquidated and agreed damages. In any event, the maximum amount of liquidated damages shall not exceed 10 % of the Contract Price.*"

Comment

Delay liquidated damages and performance liquidated damages provisions provide a much-needed degree of certainty for both parties to EPC contracts. Through such clauses, clients can rest assured that their bottom line will not be adversely affected by any construction delays or defects, while contractors can protect themselves against disproportionate damages claims. However, careful drafting of these provisions is essential in order to avoid potential disputes as to their interpretation and experienced legal counsel should always be engaged in this regard.

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Endnotes

(1) This includes industry sectors such as electricity, oil and gas, transport, water and telecommunications.

(2) *Financial Caps on Liability in Construction Contracts*, Euan McLeod and Kirsteen Milne, page 1.

(3) *Basic principles of liquidated damages*, Peter Godwin, Dominic Roughton, David Gilmore and Emma Kratochvilova.