

# Liquidated damages in EPC contracts

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## Introduction

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## Introduction

Most standard forms of engineering, procurement and construction contracts (EPC) stipulate that the contractor has a duty to complete the works by a specified time, whether by a particular date or within a set number of days, weeks or months. If there is no specified time for completion, a term will be implied into the contract such that the contractor is obliged to complete the works within a reasonable period of time. Contractors tend to use liquidated damages clauses as 'previously set' remedies, providing for compensation to the injured party upon default attributable to the other party.

As commonly defined, liquidated damages are damages whose amount is designated by the parties during the drafting of a contract for the harmed party to collect as compensation upon a specific breach (eg, late performance). If the contractor fails to complete the works by the specified time, or within a reasonable period of time, it will be in breach of contract and liable to the client in damages. Parties commonly agree that a liquidated (fixed and agreed) sum will be payable as damages for failure to complete by the specified time. Liquidated damages are often calculated on a daily or weekly basis, and as a percentage of the contract price, and should be a genuine pre-estimate of the client's loss arising from the delayed completion.

In most legal systems, a liquidated damages clause will not be enforced if its purpose is to punish the wrongdoer/party in breach, rather than to compensate the injured party<sup>(1)</sup> (in which case it is referred to as a penal or penalty clause<sup>(2)</sup>). One reason for this is that the enforcement of the term would, in effect, require an equitable order of specific performance. However, most courts will seek to achieve a fair result and will not enforce a term that will lead to the unjust enrichment of the enforcing party.<sup>(3)</sup>

However, the inclusion of a liquidated damages clause may not be equitable to both parties in terms of the balance between the legitimate interests of one party and the result outlook of the other.

## Legal insight on liquidated damages

Almost every construction contract will impose liquidated damages for delay and impose standards in relation to the quality of construction. EPC contracts impose performance liquidated damages, because the achievement of the performance guarantees has a significant impact on the ultimate success of a project.

Similarly, it is important that the facility (the result of the contractor's work) commences operation on time, because of the impact on the success of the project and because of the liability that the client will face under other agreements. This is why delay liquidated damages are imposed. Both delay liquidated damages and performance liquidated damages are used to motivate the contractor to fulfil its contractual obligations.

Liquidated damages must be a genuine pre-estimate of the client's loss. If they are more than a

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genuine pre-estimate, they will constitute a penalty and thus be unenforceable. There is no legal penalty for setting a liquidated damages rate below that of a genuine pre-estimate; however, there are financial consequences.

In addition to being unenforceable as a penalty, liquidated damages can also be void for uncertainty or unenforceable because they breach the prevention principle. 'Uncertainty' in this context means that it is impossible to determine how the liquidated damages provisions work. In such circumstances, a court will void the liquidated damages provisions.

When liquidated damages are invalidated because they constitute a penalty (ie, they do not represent a genuine pre-estimate of loss), the liquidated damages or their cap will not act as a cap on damages claims at general law. It is rare for a court to find that liquidated damages constitute penalties in contracts between two sophisticated, well-advised parties.

In addition, a liquidated damages clause will cap the contractor's liability where the liquidated damages regime breaches the prevention principle, because this gives effect to the commercial bargain struck by the parties. Further, a liquidated damages clause which is considered uncertain will be severed from the EPC contract in its entirety and will not act as a cap on the damages recoverable by the principal from the contractor. Upon severance, the clause is – for the purposes of contractual interpretation – ignored.

In short, a liquidated damages clause is generally valid and enforceable if:

- at the time that the contract was entered into, the anticipated damages in case of breach were difficult to ascertain;
- the parties mutually intended to liquidate the damages in advance; and
- the amount of liquidated damages, when viewed as of the time that the contract was made, was a reasonable estimate of the potential actual damages that the breach would cause.

The drafter of a liquidated damages clause should take care not to characterise the liquidated damages as a penalty for the contractor's untimely performance; otherwise, the client will run the risk of the clause being deemed void and unenforceable.

### **Liquidated damages clause: drafting it right**

Given the role that liquidated damages play in ensuring that EPC contracts are bankable and the abovementioned consequences of the regime not being effective, it is vital to ensure that they are properly drafted so that contractors cannot avoid their liquidated damages liability on a legal technicality.

Therefore, it is important to ensure that delay liquidated damages and performance liquidated damages are dealt with separately. If a combined liquidated damages amount is levied for late completion of the works, it risks being struck out as a penalty, because it will overcompensate the client. However, a combined liquidated damages amount levied for underperformance may undercompensate the client.

It is also important to distinguish between the different types of performance liquidated damages to protect the client against arguments by the contractor that they constitute a penalty. For example, if a single performance liquidated damages rate focuses only on output and not efficiency, problems and uncertainties will arise if the output guarantee is met, but one or more of the efficiency guarantees are not. In these circumstances, the contractor will argue that the performance liquidated damages constitute a penalty, because the loss that the client suffers if the efficiency guarantees are not met is usually smaller than if the output guarantees are not met.

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### **Endnotes**

(1) "Liquidated damages, penalties and the Just Compensation rule: Some notes on an enforcement model and a theory of efficient breach" (w). *Columbia Law Review* 77.

(2) *Id.*

(3) "Liquidated Damages" (w), *American Law Encyclopedia* 6.

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