Shylock's Construction Law: The Brave New Life of Liquidated Damages?[1]

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Construction contracts; Enforcement; Liquidated damages; Penalty clauses; Unfair contract terms

> "My deeds upon my head! I crave the law,
> The penalty and forfeit of my bond."[2]

If Shylock sought to enforce his penalty clause today, would he find vindication in the common law? One cannot help but wonder after the Supreme Court's decision in *Makdessi* and *Parking Eye*.[3] The question is far from being a mere rhetorical one, for the Supreme Court in *Makdessi* has effected a sea change in the way that the law distinguishes valid liquidated and ascertained damages (LADs) from unenforceable penalty clauses—by substituting the test of "legitimate interest" for that of "genuine pre-estimate of loss".[4] This change has been noted by commentators,[5] and "the effect of the decision is likely to reduce the impact of the penalty rule on commercial parties".[6]

This paper revisits the doctrine of penalties in the construction context, by first setting out the law as conventionally understood since the seminal case of *Dunlop*,[7] and then comparing it with the new approach in *Makdessi*. In light of the important risk allocating role of LADs in construction contracts, it is the author's thesis that the *Makdessi* approach could potentially undermine certainty and efficiency, and parties should refrain from inflating the amount of LADs in the name of "legitimate business interests".

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[2] *The Merchant of Venice* (IV.i.2147–48).
[3] *Makdessi v Cavendish Square Holding BV* [2015] UKSC 67; [2016] A.C. 1172; [2016] B.L.R. 1.
[4] *Makdessi* [2016] A.C. 1172; [2016] B.L.R. 1 at [31]–[32], per Lord Neuberger and Lord Sumption.
[5] See for example Alex Radcliffe and Erin Vickers, "The rule of penalties subjected to a through going-over" (2015) 236 IHL 24-26; Hamish Lal, "A new test for penalties" (2015) 46 *Building* 50-51; James Shackleton, "Penalties and liquidated damages law revisited" (2015) 26(10) Cons. Law 14-16; Michael Fletcher, "A masterclass in penalties" (2015) 165 (7679) NLJ 14; Natalie Appleby, "Where are we now?" (2015) 337 PLJ 6-11; Paul Joukabor and Nathan Searle, "Offside: a new test for penalty clauses" (2015) 64 Co. L.J. 4-7; and Theo Barclay, "Fair is foul and foul is fair" (2015) 159(42) SJ 38-39.
[6] See "The penalty clause rule re-considered", 2015/16 Building Law Monthly, Dec/Jan 1–5.
[7] *Dunlop Pneumatic Tyre Co Ltd v New Garage & Motor Co Ltd* [1915] A.C. 79.

I A brief history of the doctrine of penalties

(i) Early roots from equity to common law

Penalty clauses had long been devices used in Roman law and in continental Europe, and eventually made their way into English contracts in the 13th century.[8] Despite a good deal of controversy on the exact roots of the doctrine of penalties,[9] the most likely account is that the doctrine has equitable origins dating back to the practice of the Courts of Equity of granting equitable relief from penal bonds. This has been acknowledged by the Supreme Court in *Makdessi*[10] and by legal historians[11] long before that.

It is unnecessary to go much further into the historical niceties of these penal bonds—as the learned author of *McGregor on Damages* opined, "they have now only an historical interest".[12] Suffice it to say that these bonds had been an Italian innovation[13] before crossing the English Channel and finding their way into common usage in the 15th century,[14] and finally into the infamous story of Shylock.

The equitable approach was eventually extended by the courts to the common law,[15] and was even enacted in statute.[16] As penal bonds gradually fell out of fashion, the common law developed instead in the context of liquidated damages clauses from the 18th to the 20th century,[17] spawning a number of important decisions[18] through which the doctrine of penalties took shape almost autonomously.[19] Indeed, the common law went further than the Courts of Equity, as Kay LJ noted:

> "They held that, though the parties had expressly said that the sum agreed to be paid was liquidated damages and not a penalty, they would construe the agreement as meaning that it should be a penalty."[20]

This was a new direction of travel, in the sense that

[8] See Joseph Biancalana, "The development of the penal bond with conditional defeasance" (2005) 26(2) J. Legal Hist. 103-17, 103-104 and the sources cited.

[9] See Law Commission, *Penalty Clauses and Forfeiture of Monies Paid* (Working Paper No.61, 1975), para.15; *Philips Hong Kong Ltd v Attorney General of Hong Kong* 61 B.L.R. 41; (1993) 9 Const. L.J. 202 at 55, per Lord Woolf (PC).

[10] *Makdessi* [2016] A.C. 1172; [2016] B.L.R. 1 at [4]–[8], per Lord Neuberger and Lord Sumption.

[11] Joseph Story, *Commentaries on Equity Jurisprudence, as administered in England and America*, 9th edn (Little, Brown & Co, 1866), Vol.2, pp.534–535; A.W.B. Simpson, "The penal bond with conditional defeasance" (1966) 82 LQR 392; D.J. Ibbetson, *A Historical Introduction to the Law of Obligations* (OUP, 2002), pp.213-214; Matthew Bell, "Liquidated damages and the doctrine of penalties: rethinking the war on terrorem" (2012) 29(4) I.C.L. Rev. 386-405, 393-394.

[12] Harvey McGregor QC, *McGregor on Damages*, 19th edn with 1st supplement (Sweet & Maxwell, 2015), para.15-004.

[13] Frederick Pollock and Frederic William Maitland, *The History of English Law before the Time of Edward I*, 2nd edn (CUP, 1898), Vol.2, p.227.

[14] Biancalana, "The development of the penal bond with conditional defeasance" (2005) 26(2) J. Legal Hist. 103-117, 116-117.

[15] Simpson, "The penal bond with conditional defeasance" (1966) 82 L.Q.R. 392, 418–419.

[16] Administration of Justice Act 1696 (8 & 9 Will 3 c.11) and Administration of Justice Act 1705 (4 & 5 Anne c.16), both now repealed; see McGregor, *McGregor on Damages*, 19th edn with 1st supplement (2015), para.15-003; *Makdessi* [2016] A.C. 1172; [2016] B.L.R. 1 at [6], per Lord Neuberger and Lord Sumption.

[17] McGregor, *McGregor on Damages*, 19th edn with 1st supplement (2015), paras 15-005–15-007.

[18] See for example *Lowe v Peers* 98 E.R. 160; (1768) 4 Burr. 2225; *Astley v Weldon* 126 E.R. 1318; (1801) 2 Bos. & P. 346; *Kemble v Farren* 130 E.R. 1234; (1829) 6 Bing. 141;*Betts v Burch* 157 E.R. 938; (1859) 4 Hurl. & N. 506; *Wall v Rederi AB Luggude* [1915] 3 K.B. 66.

[19] McGregor, *McGregor on Damages*, 19th edn with 1st supplement (2015), para.15-006.

[20] *Law v Redditch Local Board* [1892] 1 Q.B. 127 at 134.

> "[t]he law relieved the contract breaker of the consequences not because the objective could be secured in another way but because the objective was contrary to public policy and should not therefore be given effect at all".[21]

As observed by the Inner House of the Court of Session, "the law will not let people punish each other".[22]

The evolution of the Court of Equity's approach is important in two respects. First, it is noteworthy that equity originally intervened on the basis that penalty bonds were merely an accessory security for the performance of a collateral object—a principle described as "too strongly established in equity to be shaken".[23] In the words of one legal historian, the applicable test was as follows:

> "In every case, the true test by which to ascertain whether relief can be had in equity is, to consider whether compensation can be made or not. … If it is to secure the performance of some collateral act or undertaking … when the amount of damages is ascertained by a jury, upon the trial of such an issue, they will grant relief upon payment of such damages."[24]

Thus, the equitable principles aimed to prevent overcompensation of the promisee. This strikes a chord with the *Dunlop* test of "genuine pre-estimate of loss" and the "classic form of relief against such penalty clauses", which is "to refuse to give effect to it, but to award the common law measure of damages".[25]

Secondly, the development of the common law before *Dunlop* was also broadly consonant with a focus on whether the clause reflected an intention to assess the damages for a breach. It had little if anything to do with fairness, for "parties are at liberty to enter into any bargain they please".[26] In a construction dispute in 1892, this was the test proposed:

> "If the intention is to secure performance of the contract by the imposition of a fine or penalty, then the sum specified is a penalty; but if, on the other hand, the intention is to assess the damages for breach of the contract, it is liquidated damages."[27]

(ii) Dunlop and subsequent developments

For over a century, Lord Dunedin's enunciation of the doctrine of penalties in *Dunlop* has "achieved the status of a quasi-statutory code".[28] The courts have described it as the "classic definition of a penalty clause",[29] "authoritatively set

[21] *Makdessi* [2016] A.C. 1172; [2016] B.L.R. 1 at [7].
[22] *Robertson v Alexander* (1881) 8 R. 555 at 562, per Lord Young.
[23] *Sloman v Walter* 28 E.R. 1213; (1783) 1 Bro. C.C. 418 at 419, per Lord Thurlow LC.
[24] Joseph Story, *Commentaries on Equity Jurisprudence, as administered in England and America*, 9th edn (Little, Brown & Co, 1866), Vol.2, p.535; see also *Peachy v Duke of Somerset* 93 E.R. 626; (1720) 1 Str. 447 at 453, per Lord Macclesfield.
[25] *Scandinavian Trading Tanker Co AB v Flota Petrolera Ecutoriana (The Scapetrade)* [1983] 2 A.C. 694; at 702, per Lord Diplock; [1983] 3 W.L.R. 203; [1983] 2 All E.R. 763.
[26] *Betts* 157 E.R. 938; (1859) 4 Hurl. & N. 506 at 509, perMartin B.
[27] *Law v Redditch* [1892] 1 Q.B. 127 at 132, per Lopes LJ.
[28] *Makdessi* [2016] A.C. 1172; [2016] B.L.R. 1 at [22], per Lord Neuberger and Lord Sumption.
[29] *Azimut-Benetti SpA v Healey* [2010] EWHC 2234 (Comm); [2011] 1 Lloyd's Rep. 473; [2010] T.C.L.R. 7 at [19], per Blair J.

out in the speech of Lord Dunedin",[30] and the "classic statement of the law",[31] which has "often been cited and relied upon for the last 90 years".[32] Other common law jurisdictions have expressed similar views.[33] This is not at all surprising, given that "the present position was only reached through the influence of Scots law and Commonwealth jurisprudence".[34]

Academics and practitioners have also described it as "the historic definitive ruling"[35] and "the bedrock of the law",[36] which has traditionally been treated as an "exhaustive dichotomy"[37] between a genuine pre-estimate of loss and an extravagant and unconscionable penalty. In construction law, practitioners have seen this as "probably the most important test to be applied".[38]

The importance of *Dunlop* thus lies in its authoritative consolidation of the doctrine of penalties. After reaffirming that the parties' use of the labels "penalties" or "liquidated damages" is "not conclusive", Lord Dunedin expressed the distinction between liquidated damages and penalties:

> "The essence of a penalty is a payment of money stipulated as *in terrorem* of the offending party; the essence of liquidated damages is a genuine covenanted pre-estimate of damage."[39]

His Lordship then stressed that the determination of whether a clause is a penalty is

> "a question of construction to be decided upon the terms and inherent circumstances of each particular contract, judged as at the time of the making of the contract".[40]

Crucially, Lord Dunedin set out "four rules of construction",[41] the most important of which is that a clause will be penal

> "if the sum stipulated for is extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have followed from the breach".[42]

[30] *Philips* 61 B.L.R. 41; (1993) 9 Const. L.J. 202 at 56, per Lord Woolf.

[31] *Indian Airlines Ltd v GIA International Ltd* [2002] EWHC 2361 (Comm) at [69], per Tomlinson J; *Jeancharm Ltd (t/a Beaver International) v Barnet Football Club Ltd* [2003] EWCA Civ 58; 92 Con. L.R. 26 at [9], per Jacob J; *Murray v Leisureplay Plc* [2005] EWCA Civ 963; [2005] I.R.L.R. 946 at [34], per Arden LJ and at [110], per Buxton LJ.

[32] Alfred *McAlpine Capital Projects Ltd v Tilebox Ltd* [2005] EWHC 281 (TCC); [2005] B.L.R. 271; 104 Con. L.R. 39, at [42] per Jackson LJ.

[33] *Dunlop* [1915] A.C. 79 was called a "landmark" decision in *AMEV-UDC Finance Ltd v Austin* (1986) 162 CLR 170 (HCA) at 193, per Mason and Wilson JJ (also (1987) 68 A.L.R. 185), and has been "applied countless times" according to *Ringrow Pty Ltd v BP Australia Pty Ltd* [2005] HCA 71; (2005) 224 CLR 656 at [12] per Gleeson CJ, Gummow, Kirby, Hayne, Callilan and Heydon JJ.

[34] *Murray* [2005] I.R.L.R. 946 at [30], per Arden LJ.

[35] Brian Eggleston, *Liquidated Damages and Extensions of Time in Construction Contracts*, 3rd edn (Wiley-Blackwell, 2008), p.81.

[36] Bell, "Liquidated damages and the doctrine of penalties: rethinking the war on terrorem" (2012) 29(4) I.C.L. Rev. 386-405, 395.

[37] *Chitty on Contracts*, edited by H.G. Beale, 32nd edition (London: Sweet & Maxwell, 2015), para.26-182.

[38] Vivian Ramsey and Stephen Furst (eds), *Keating on Construction Contracts*, 9th edn (London: Sweet & Maxwell, 2015), p.366.

[39] *Dunlop* [1915] A.C. 79 at 86.

[40] *Dunlop* [1915] A.C. 79 at 86–87.

[41] Nicholas Dennys, Mark Raeside and Robert Clay (eds), *Hudson's Building and Engineering Contracts*, 12th edn with 4th supplement (London: Sweet & Maxwell, 2014), para.6-022.

[42] Dennys, Raeside and Clay (eds), *Hudson's Building and Engineering Contracts*, 12th edn with 4th supplement (2014), para.87-88.

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It is important to note that the phrase "extravagant and unconscionable" was not so much an autonomous test introducing a distinct ingredient as a convenient descriptor for the type of cases in which a clause did not reflect a genuine estimate of loss. It denotes the very antithesis of "a fair and reasonable sum for liquidated damages".[43] This is clear from Lord Dunedin's observation that "provided that figure is not extravagant there would seem no reason to suspect that it is not truly a bargain to assess damages",[44] as well as from the other speeches.[45]

The English courts have had ample opportunity over the course of a century to consider the application of the *Dunlop* test. In the important Privy Council decision of *Philips*, Lord Woolf reaffirmed and applied the "genuine pre-estimate of loss" test,[46] making it clear however that

> "it will normally be insufficient to establish that a provision is objectionably penal to identify situations where the application of the provision could result in a larger sum being recovered by the injured party than his actual loss".[47]

The *Dunlop* test saw its "recasting in more modern terms"[48] by Coleman J, whose formulation of the test has proven authoritative in more recent cases

> "..whether a provision is to be treated as a penalty is a matter of construction to be resolved by asking whether at the time the contract was entered into the predominant contractual function of the provision was to deter a party from breaking the contract or to compensate the innocent party for breach".[49]

Case law in the 21st century has not veered far from the *Dunlop* principles. While the courts can have regard to many factors and circumstances,[50] it has been acknowledged that two particular factors are crucial, namely the degree of disproportion (oppressiveness) and the relationship of the parties (unconscionability).[51]

This is not to say that the test is one of inequality of bargaining powers, as Keene LJ stressed in *Jeancharm*, and

> "the test … remains one of ascertaining whether the provision is a genuine pre-estimate of loss or is a penalty for non-performance of the contractual obligation".[52]

Similarly, Peter Gibson LJ reiterated the traditional approach.[53]

Further authoritative guidance was given by Jackson J in a construction dispute arising from late completion, emphasising that a pre-estimate need not be "correct" or "honest" to be objectively genuine.[54]

[43] *Dunlop* [1915] A.C. 79 at 91, per Lord Atkinson, at 99, per Lord Parker.
[44] *Dunlop* [1915] A.C. 79 at 88.
[45] See for example Lord Pamoor in *Dunlop* [1915] A.C. 79 at 101: "To justify interference there must be an extravagant disproportion between the agreed sum and the amount of any damage capable of pre-estimate".
[46] Eggleston, *Liquidated Damages and Extensions of Time in Construction Contracts*, 3rd edn (2008), p.86.
[47] *Philips* 61 B.L.R. 41; (1993) 9 Const. L.J. 202 at 58–9.
[48] As described in *Murray* [2005] I.R.L.R. 946 at [110], per Buxton LJ; also at [106], per Clarke LJ.
[49] *Lordsvale Finance Plc v Bank of Zambia* [1996] Q.B. 752 at 762; [1996] 3 W.L.R. 688; [1996] C.L.C. 1849.
[50] Eggleston, *Liquidated Damages and Extensions of Time in Construction Contracts*, 3rd edn (2008), p.79.
[51] *Indian Airlines* [2002] EWHC 2361 (Comm) at [72], per Tomlinson J.
[52] *Jeancharm* 92 Con. L.R. 26 at [22].
[53] *Jeancharm* 92 Con. L.R. 26 at [27]–[28].
[54] *McAlpine v Tilebox* [2005] B.L.R. 271; 104 Con. L.R. 39 at [48].

Last but not least, in *Murray*, the majority in the Court of Appeal adhered to *Dunlop* and preferred a "broad and general" approach.[55] Above all, Buxton LJ pointed out that

> "[i]t is important to note that the two alternatives, a deterrent penalty; or a genuine pre-estimate of loss; are indeed alternatives, with no middle ground between them".[56]

(iii) Paving the path to Makdessi?

The foregoing survey of the key cases serves to show that the law is for most purposes unambiguous and "well settled".[57] As Mathew Bell accepted in a recent article, "generally speaking, and as is reflected in the modern cases … the key principles are applied in a fairly consistent manner".[58]

It is certainly true that both in England and in the wider commonwealth, the doctrine of penalties has been subject to significant criticisms.[59] Roy Goode observed that "judges remain sharply divided as to the fundamental objective of the rule and the circumstances in which it may be invoked".[60] Stephen Smith also described the court's attitude to the doctrine as "fluctuating".[61]

After the turn of the century, it has been said that "while certain principles are clear, there still exist a number of 'grey areas' in the law governing this subject",[62] and one commentator opined that the question of penalties is "laden with jurisprudential tension, rich in judicial commentary and of fundamental legal, practical and commercial significance for construction lawyers and decision makers".[63]

In Australia, it was said that the doctrine is "an assortment of notions; a jumble of historical curiosities which out of context override no unitary rationale",[64] and that "there remains sufficient uncertainty in the law to make it worthwhile for the breaching party to challenge the agreement".[65] John Carter and Elisabeth Peden have pointed out the "inconsistencies" and "complexities" in the doctrine.[66] Similar

[55] *Murray* [2005] I.R.L.R. 946 at [114], per Buxton LJ and at [106], per Clarke LJ.
[56] *Murray* [2005] I.R.L.R. 946 at [111].
[57] *Lansat Shipping Co Ltd v Glencore Grain BV (The Paragon)* [2009] EWHC 551 (Comm); [2009] 2 All E.R. (Comm) 12; [2009] 1 Lloyd's Rep. 658 at [17], per Blair J.
[58] Bell, "Liquidated damages and the doctrine of penalties: rethinking the war on terrorem" (2012) 29(4) I.C.L. Rev. 386-405, 393.
[59] See Paula D. Baron, "Confused in Words: Unconscionability and the Doctrine of Penalties" (2008) 34(2) *Monash University Law Review* 285-308, 287.
[60] Roy Goode, "Penalties in Finance Leases" (1988) 104 L.Q.R. 25-29.
[61] Stephen A. Smith, *Atiyah's Introduction to the Law of Contract*, 6th edn (OUP, 2005), p.392.
[62] Thomas Thompson, "A Fresh Look at Liquidated Damages" (2006) 22 Const. L.J. 289-306, 289.
[63] Hamish Lal, "Liquidated Damages" (2009) 25 Const. L.J. 569-590, 569.
[64] Garry A. Muir, "Stipulations for the Payment of Agreed Sums" (1985) 10 *Sydney Law Review* 503, 516.
[65] Andrew Ham, "The Rule Against Penalties in Contract: An Economic Perspective" (1990) 17 *Melbourne University Law Review* 649-670, 650.
[66] John Carter and Elisabeth Peden, "A Good Faith Perspective on Liquidated Damages" (2007) 23 J.C.L. 157, 158.

views have been expressed across the Atlantic.[67] Undoubtedly, "there is a wealth of literature on the doctrine of penalties, the majority of which is critical".[68]

Three points have to be made to put things into perspective. First, it is important to note that the criticism

> "generally focuses upon three issues: the tension between the doctrine and freedom of contract; the economic inefficiency of the doctrine; and the lack of a clear delineation between a valid agreed sums clause and an invalid penalty".[69]

Much of the literature addresses the former two.

Secondly, the courts have consistently emphasised that it only exercises a supervisory jurisdiction and is generally slow to intervene in the parties' bargains. The classic statement is that of Diplock LJ:

> "The court should not be astute to descry a 'penalty clause' in every provision of a contract which stipulates a sum to be payable by one party to the other in the event of a breach by the former".[70]

In *Philips*, Lord Woolf similarly stressed that "the court should not adopt an approach to provisions as to liquidated damages which could … defeat their purpose".[71] His Lordship cited the Australian case of *AMEV-UDC* and the Canadian case of *Elsy*.[72]

In recent cases, judges have continued to recognise the fundamental principle of *pacta sunt servanda* and freedom of contract, and have accordingly expressed the need for great caution before striking down a liquidated damages clause as a penalty.[73] The crystallisation of this approach could be seen in *McAlpine v Tilebox*:

> "[T]he courts are predisposed, where possible, to uphold contractual terms which fix the level of damages for breach. This predisposition is even stronger in the case of commercial contracts freely entered into between parties of comparable bargaining power."[74]

Therefore, it has been observed that "the modern approach of the courts is to uphold liquidated damages provisions if at all possible".[75] The criticisms in respect of the

[67] See for example Charles J. Goetz and Robert E. Scott, "Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach" (1977) 77 Columbia L. Rev. 554; Kenneth Clarkson, Roger Miller and Timothy Murrs, "Liquidated Damages v Penalties: Sense or Nonsense" [1978] Wisconsin L. Rev. 351; Robert Hillman, "The Limits of Behavioural Decision Theory in Legal Analysis: The Case of Liquidated Damages" (1990–2000) 85 Cornell L. Rev. 717, 726; L.A. DiMatteo, "A Theory of Efficient Breach: Eliminating the Law of Liquidated Damages" (2001) 38 American Business L.J. 633; L.A. DiMatteo, "Penalties as Rational Response to Bargaining Irrationality" (2006) Michigan State L. Rev. 883.

[68] Paula D. Baron, "The Doctrine of Penalties and the Test of Commercial Justification" (2008) 34 U.W.A. L. Rev. 42-58, 44.

[69] Baron, "The Doctrine of Penalties and the Test of Commercial Justification" (2008) 34 U.W.A. L. Rev. 42-58, 45.

[70] *Robophone Facilities Ltd v Blank* [1966] 1 W.L.R. 1428 at 1447; [1966] 3 All E.R. 128; (1966) 110 S.J. 544.

[71] *Philips* 61 B.L.R. 41; (1993) 9 Const. L.J. 202 at 58.

[72] *AMEV-UDC* (1986) 162 CLR 170 (HCA) at 193, per Mason and Wilson JJ; *Elsy v JG Collins Insurance Agencies Ltd* [1978] 83 DLRI 15 (Supreme Court of Canada). These cases were also cited to make the same point in *Indian Airlines* [2002] EWHC 2361 (Comm) at [71]–[72], per Tomlinson J.

[73] *Jeancharm* 92 Con. L.R. 26 at [15], per Jacob J; *Murray* [2005] I.R.L.R. 946 at [43], per Arden LJ, at [106], per Clarke LJ and at [114], per Buxton LJ.

[74] *McAlpine v Tilebox* [2005] B.L.R. 271; 104 Con. L.R. 39 at [48], per Jackson J.

[75] Dennys, Raeside and Clay (eds), *Hudson's Building and Engineering Contracts*, 12th edn 4th supplement (2014), para.6-045.

lack of certainty and the violation of the freedom of contract doctrine are, in reality, academic. Indeed, much of the critique cited was proliferated at a time prior to these judicial developments.

Thirdly, in the construction context at least, the doctrine of penalties has not been very problematic in practice. In *McAlpine v Tilebox*, Jackson J noted that only four of the cases cited resulted in a finding of a penalty clause, all of which involved a "very wide gulf".[76] Criticisms of uncertainty do not carry much force. As the learned editors of *Hudson* observed, "there are no recent reported cases where the amount of liquidated damages agreed in a construction contract have been held to be penal".[77]

Mathew Bell also accepts that "the current consensus appears to be that the balance is, on the whole, being struck appropriately", citing Solene Rowan's comment in this regard:

> "Parties of comparable bargaining power that enter into commercial contracts can now expect that as long as their agreed damages provisions are not extravagant, they are unlikely to be the subject of judicial intervention. A *reasonable* deterrent effect is tolerated …"[78]

Notwithstanding all of the above, the Supreme Court in *Makdessi* ventured to change the law, as if on an epic crusade to the east for the elusive holy grail, not knowing that it has by some misfortune headed west instead. It set out to do so with a sweeping statement:

> "For many years, the courts have struggled to apply standard tests formulated more than a century ago for relatively simple transactions to altogether more complex situations. The application of the rule is often adventitious. The test for distinguishing penal from other principles is unclear."[79].

II The new test under *Makdessi*

The Supreme Court in *Makdessi* undertook a detailed analysis of *Clydebank*[80] and the speeches in *Dunlop*,[81] casting doubts on the status of Lord Dunedin's speech. The court then noted and approved the recent authorities developing a broader test of "commercial justification".[82]

Not surprisingly, the Supreme Court took a rather dim view of the law as it stood. Lord Neuberger and Lord Sumption described the doctrine as a "prisoner of artificial categorisation" based on "unsatisfactory distinctions" between a penalty

[76] *McAlpine v Tilebox* [2005] B.L.R. 271; 104 Con. L.R. 39 at [48], per Jackson J.

[77] Dennys, Raeside and Clay (eds), *Hudson's Building and Engineering Contracts*, 12th edn (2014), 4th supplement, para.6-045; compare the exceptional case of *Braes of Doune Wind Farm (Scotland) Ltd v Alfred McAlpine Business Services Ltd* [2008] EWHC 426 (TCC); [2008] 2 All E.R. (Comm) 493; [2008] 1 Lloyd's Rep 608.

[78] Solene Rowan, "For the recognition of remedial terms agreed inter partes" (2010) 126 L.Q.R. 448-475, 463.

[79] *Makdessi* [2016] A.C. 1172; [2016] B.L.R. 1 at [3], per Lord Neuberger and Lord Sumption.

[80] *Clydebank Engineering & Shipbuilding Co Ltd v Don Jose Ramos Yzquierdo y Castaneda* [1905] A.C. 6; (1904) 7 F. (H.L.) 77; (1904) 12 S.L.T. 498. See *Makdessi* [2016] A.C. 1172; [2016] B.L.R. 1 at [20], per Lord Neuberger and Lord Sumption, at [132]–[134], per Lord Mance, and at and [244]–[246], per Lord Hodge.

[81] *Makdessi* [2016] A.C. 1172; [2016] B.L.R. 1 at [21]–[24], per Lord Neuberger and Lord Sumption, at [135]–[143], per Lord Mance, and at [247], per Lord Hodge.

[82] *Makdessi* [2016] A.C. 1172; [2016] B.L.R. 1 at [21]–[24], per Lord Neuberger and Lord Sumption, at [135]–[143], per Lord Mance, at [25]–[28], per Lord Neuberger and Lord Sumption, at [145]–[151], per Lord Mance and at [235], per Lord Hodge.

and a genuine pre-estimate of loss,[83] as well as an "interference with freedom of contract" which "undermines the certainty which parties are entitled to expect of the law".[84] Above all, their Lordships acknowledged that "[a]ll definition is treacherous as applied to such a protean concept".[85] These criticisms fall in line with those raised by many others in support of abolishing the doctrine.[86]

Nonetheless, the Supreme Court refused to abolish the doctrine.[87] Instead, it substituted the *Dunlop* test as traditionally understood with the "true" and "correct" test:

> "The true test is whether the impugned provision is a secondary obligation which imposes a detriment on the contract-breaker out of all proportion to any legitimate interest of the innocent party in the enforcement of the primary obligation."[88]

Put in a slightly different and more concise way:

> "What is necessary in each case is to consider, first, whether any (and if so what) legitimate business interest is served and protected by the clause, and, second, whether, assuming such an interest to exist, the provision made for the interest is nevertheless in the circumstances extravagant, exorbitant or unconscionable."[89]

With these words, the Supreme Court rang the death knell of Lord Dunedin's century-long monopoly over the doctrine of penalties. No longer are parties required to justify liquidated damages clauses as a genuine pre-estimate of loss. Instead, they are to focus on the "legitimate business interest" protected by a clause.

III The purpose of LADs in construction contracts

Before embarking on any critique of the new *Makdessi* test, it is necessary to first outline the key purpose and benefits of LADs in construction contracts. The construction industry is certainly no stranger to LADs, for its use "as an employer's remedy for a contractor's delay in completing the works is well established".[90] Perhaps for this reason, the purpose of LADs is not often articulated in negotiations:

> "The purpose behind a liquidated damages clause is simple. Where there has been a breach of contract, leading to delayed completion or delivery, rather than require the innocent party to itemise and proof his financial losses to the nth degree, the parties will be 'commercial'. They will have agreed in advance what the cost of the contractor's or supplier's delay means, usually as a weekly or daily cost."[91]

[83] *Makdessi* [2016] A.C. 1172; [2016] B.L.R. 1 at [31], per Lord Neuberger and Lord Sumption.
[84] *Makdessi* [2016] A.C. 1172; [2016] B.L.R. 1 at [33], per Lord Neuberger and Lord Sumption.
[85] *Makdessi* [2016] A.C. 1172; [2016] B.L.R. 1 at [31], per Lord Neuberger and Lord Sumption.
[86] See the literature cited above in fn.67; also Sarah Worthington, "Common Law Values: The Role of Party Autonomy in Private Law" in Andrew Robertson and Michael Tilbury (eds), *The Common Law of Obligations* (Hart Publishing, 2015), para.18-26.
[87] *Makdessi* [2016] A.C. 1172; [2016] B.L.R. 1 at [36]–[39], per Lord Neuberger and Lord Sumption, at [162]–[170], per Lord Mance and at [256]–[267], per Lord Hodge.
[88] *Makdessi* [2016] A.C. 1172; [2016] B.L.R. 1 at [32], per Lord Neuberger and Lord Sumption.
[89] *Makdessi* [2016] A.C. 1172; [2016] B.L.R. 1 at [152], per Lord Mance; see also at [255], per Lord Hodge. Lord Clarke, at [291], and Lord Toulson at [293], also agreed with the reformulated test.
[90] Shackleton, "Penalties and liquidated damages law revisited" (2015) 26(10) Cons. Law 14–16, 14.
[91] Paul Newman, "Liquidated Damages", 2007 Construction Newsletter, June, 44–45, 44.

The benefits could be further expanded as follows.[92]

1) Employers and contractors can go through the various components of delay-dependent costs to be borne by each party and consider "the single point interface between employer and contractor".[93]
2) Where damages for delay are difficult to quantify, a pre-estimation is especially appropriate to avoid the difficulty and cost of later having to prove it in court.[94] LADs could thus act as a "saver of disputes".[95]
3) Further, employers have "certainty on the consequences of certain breaches by the contractor", as an employer "can usually make a deduction for what he is owed from payments due to the contractor".[96]
4) LADs also assist employers in comparing and evaluating tenders in the tendering process, since the tenders are likely to have "priced the contingency of delay in a uniform way".[97]
5) On the other hand, a contractor benefits in the tendering process by "knowing the extent of its liability for those breaches enabling it to price its risk early on".[98]
6) During project execution, a contractor can "evaluate the cost of forfeiting liquidated damages to the employer as against the cost to himself of putting greater resources into the project to accelerate progress".[99]

The courts have long recognised the purpose and "good business sense" of LADs. This has been explained fully in an oft-cited paragraph from *Robophone*:

> "Not only does it enable the parties to know in advance what their position will be if a breach occurs and so avoid litigation at all, but if litigation cannot be avoided, it eliminates what may be the very heavy legal costs of proving the loss actually sustained …"[100]

This is why the doctrine of penalties has been given a restrictive application in the construction context. Any other approach would, in Lord Woolf's words

> "not be in the interest of either of the parties to the contract since it is to their advantage that they should be able to know with a reasonable degree of

[92] For an economic perspective, see for example William M. Landes and Richard A. Posner, "Adjudication as a Private Good" (1979) 8(2) J. Legal Studies 235, 253-284; Samuel A. Rea Jr, "Efficiency implications of penalties and liquidated damages" (1984) 13(1) J. Legal Studies 147-167; Jeremy Thorpe, "Economists Divided—Different Perceptions of Contracts Penalty Doctrine" (1994) 6(2) Bond L.R. 189-209, 200-202.

[93] Jonathan Hosie, "The assessment of damages for delay in construction contracts: liquidated and unliquidated damages" (1994) 10 Const. L.J. 214-224, 217.

[94] Hosie, "The assessment of damages for delay in construction contracts: liquidated and unliquidated damages" (1994) 10 Const. L.J. 214-224, 215.

[95] *Temloc Ltd v Errill Properties Ltd* 39 B.L.R. 30; 12 Con. L.R. 109; (1988) 4 Const. L.J. 63 (Croome-Johnson LJ); see also Baron, "Confused in Words: Unconscionability and the Doctrine of Penalties" (2008) 34(2) *Monash University Law Review* 285-308, 286.

[96] Vijay Bange, "Reducing risk with liquidated damages" (2015) 26(4) Cons. Law 6-7, 7.

[97] Hosie, "The assessment of damages for delay in construction contracts: liquidated and unliquidated damages" (1994) 10 Const. L.J. 214-224, 216.

[98] Bange , "Reducing risk with liquidated damages" (2015) 26(4) Cons. Law 6-7, 7.

[99] Hosie, "The assessment of damages for delay in construction contracts: liquidated and unliquidated damages" (1994) 10 Const. L.J. 214-224, 216.

[100] *Robophone* [1966] 1 W.L.R. 1428 at 1447, per Diplock LJ; [1966] 3 All E.R. 128; (1966) 110 S.J. 544; cited in *Murray* [2005] I.R.L.R. 946 at [66], per Arden LJ, at [106], per Clarke LJ and at [114], per Buxton LJ.

> certainty the extent of their liability and the risks which they run as a result of entering into the contract. This is particularly true in the case of building and engineering contracts."[101]

IV Potential problems with *Makdessi*

The Supreme Court's decision in *Makdessi* is arguably "one of the most important ever in the context of the common law and construction law".[102] Parties intending to enter into a construction contract invariably ask themselves what the correct and commercially acceptable figure is for LADs. The law on penalties guides the consideration of this question, and *Makdessi* may prove problematic in this context.

Before *Makdessi*, whether a LADs clause was enforceable boiled down to the question of

> "whether the sum stipulated by the employer is designed to compensate him for the loss which he can foresee, at the time of tender, as the likely consequence of late completion".[103]

The new test after *Makdessi*, however, is radically different. In the context of a construction contract

> "a so-called liquidated damages clause for delay to completion is an (unenforceable) penalty if it imposes a number (£x/day) on the contractor that is out of all proportion to any legitimate interest of the employer/owner/developer in achieving the target completion date".[104]

Comparing the two tests, it is quite clear that whereas the previous test of "genuine pre-estimate of loss" provides a clear conceptual guideline for parties to set as accurate a figure as possible to compensate for their potential losses, the *Makdessi* test could become open season for parties to assert "any legitimate interest" and set an arbitrary sum. While admittedly both tests look for a disproportion in the agreed sum, the *Dunlop* test provides a quantifiable benchmark in the form of the greatest possible financial loss, unlike an intangible "business interest".

The author does not dispute that there could theoretically be benefits in the flexibility of the *Makdessi* test. Indeed, the Supreme Court may well be right in upholding the clauses in the *Makdessi* and *Parking Eye* appeals, both of which fall into the category of unusual cases—the former concerned the forfeiture of deferred payments in the sale of a company, and the latter involved an £85 charge for overstaying beyond the two hour free parking period.

However, in refashioning the test to fit these cases, the Supreme Court may have thrown the baby out with the bathwater, opening up a massive loophole in the law, when the *Dunlop* test dealt with the bulk of everyday situations satisfactorily, as pointed out above. Practically speaking, the open-ended nature of the test is a double edged sword which could undermine the key purpose of certainty in LADs.

[101] *Philips* 61 B.L.R. 41 at 54; (1993) 9 Const. L.J. 202 at 54.
[102] Hamish Lal, "Refs to review penalties" (2015) 34 *Building* 38-39, 39.
[103] Thompson, "A Fresh Look at Liquidated Damages" (2006) 22 Const. L.J. 289-306, 304.
[104] Hamish Lal, "A new test for penalties" (2015) 46 *Building* 50-51, 50.

1) In demolishing the *Dunlop* dichotomy and holding that "[t]he real question when a contractual provision is challenged as a penalty is whether it is penal, not whether it is a pre-estimate of loss",[105] the entire inquiry risks becoming circular and tautologous. There is little concrete guidance for the construction industry on whether or not a clause is penal.
2) The new "legitimate interest" test draws heavily from the concept of "commercial justification". As Paula Baron observed, "the commercial justification test seems unlikely to create greater certainty", as it is "not difficult to imagine that courts will be faced with disputes as to what constitutes a 'commercial justification'".[106] The same uncertainty is likely to plague the *Makdessi* test.
3) Further, the *Makdessi* test could effectively become a test of unconscionability and substantive fairness.[107] Indeed, the test is now focused on whether the agreed sum is "exorbitant or unconscionable", and Lord Hodge recognised that this involves a "value judgment".[108] This should sound a few alarm bells for lawyers, as unconscionability is a notoriously elusive concept, and there is "uncertainty in the meaning and application of unconscionability in the context of the doctrine of penalties".[109] Even in the law of equity, it has been noted that unconscionability would "serve only to obscure the nature and operation of the essential characteristics" of doctrines.[110] The court has expressed similar sentiments in this context,[111] and stressed that unconscionability is not "a panacea for adjusting any contract … when it shows a rough edge to one side or the other".[112]
4) As a result, the *Makdessi* test potentially creates a host of uncertainties. Employers may be tempted to stipulate larger sums of LADs to incentivise timely completion, generating disputes about whether the clauses pursue a legitimate interest. Ironically, the purpose of LADs in creating certainty and minimising litigation "may well be undermined by the uncertainty", as "liquidated damages

[105] *Makdessi* [2016] A.C. 1172; [2016] B.L.R. 1 at [31], per Lord Neuberger and Lord Sumption.

[106] Baron, "The Doctrine of Penalties and the Test of Commercial Justification" (2008) 34 U.W.A. L. Rev. 42-58, 57.

[107] Compare the Australian approach in *Ringrow* [2005] HCA 71; (2005) 224 CLR 656, 669. Paula Baron took the view in "Confused in Words: Unconscionability and the Doctrine of Penalties" (2008) 34(2) *Monash University Law Review* 285-308, 295 that the "out of all proportion" test looks at a provision's oppressiveness and amounts to a test of fairness.

[108] *Makdessi* [2016] A.C. 1172; [2016] B.L.R. 1 at [249].

[109] Baron, "Confused in Words: Unconscionability and the Doctrine of Penalties" (2008) 34(2) *Monash University Law Review* 285-308, 286; see also Elizabeth Lanyon, "Equity and the Doctrine of Penalties" (1996) 9 JCL 234, 258: "it is unsatisfactory to make general appeals to fairness and unconscionability. Modification or expansion of the penalties doctrine must be principled and based on clearly articulated policy foundations".

[110] John McGhee (ed.), *Snell's Equity*, 33rd edn (London: Sweet & Maxwell, 2015), para.12-010; see also the Preface to the 30th edition in 2000, which opined that frequent references by the court to "unconscionability" has "masked rather than illuminated the underlying principles at stake".

[111] Lord Scott observed in *Cobbe v Yeoman's Row Management Ltd* [2008] UKHL 55; [2008] 1 W.L.R. 1752; [2008] 4 All E.R. 713 at [16]: "To treat a 'proprietary estoppel equity' as requiring neither a proprietary claim by the claimant nor an estoppel against the defendant but simply unconscionable behaviour is, in my respectful opinion, a recipe for confusion." See also Mummery LJ in the Court of Appeal [2006] EWCA Civ 1139; [2006] 1 W.L.R. 2964; [2007] 1 P. & C.R. 8 at [2]: "simply doing what the court thinks is just and equitable on the facts of each individual case is liable to increase uncertainty".

[112] *Bridge v Campbell Discount Co Ltd* [1962] A.C. 600 at 622, per Lord Radcliffe; [1962] 2 W.L.R. 439; [1962] 1 All E.R. 385.

clauses may actually generate, rather than alleviate, costs and litigation".[113]

Moreover, insofar as *Makdessi* could pave the way to a shift in contractual risk allocation, inflating the sums of LADs to be imposed on contractors and subcontractors, the decision potentially generates economic inefficiencies.

1) The "genuine pre-estimate of loss" test served a channelling, cautionary and evidentiary function like legal formalities.[114] That would be lost if parties are no longer required to apply their minds to risk allocation or try to estimate potential losses in fixing LADs, although the evidentiary function may still be served by a record of the business interests.
2) Risk allocation should normally follow the so-called "Abrahamson principles", under which risks should be allocated to the party who inter alia could efficiently control the risk or could economically transfer the risk through insurance or otherwise.[115]
3) As "a common aim of owners appears to be to avoid risk as far as possible by allocating as many risks as it can to the contractor"[116] the broad approach in *Makdessi* may encourage employers to increase the figures for LADs and shift more time risks to contractors, hampering the overall economic efficiency of construction projects.
4) The danger of this happening is exacerbated by the fact that contractors are often in a weaker bargaining position when it comes to completion time and LADs. In practice, the "vast majority of construction contracts today are set by the employer", and "the contractor's only contribution to the agreement is the tender sum".[117] Objections to the amount of LADs may be seen as incompetence or lack of confidence.
5) Thus, the likely effect of inflated LADs and unbalanced risk allocation is that the employer ends up paying an inflated price as a result of loading built into the tender by contractors to offset the contingency,[118] and this may lead to an industry-wide inflation beyond optimum project costs.
6) However, increasing the tender price runs the risk of reducing the competitiveness of bids.[119] There are two possible scenarios. A significant number of contractors may be deterred from submitting

[113] Baron, "Confused in Words: Unconscionability and the Doctrine of Penalties" (2008) 34(2) *Monash University Law Review* 285-308, 286; see also Thorpe, "Economists Divided—Different Perceptions of Contracts Penalty Doctrine" (1994) 6(2) Bond L.R. 189-209, 207; Kenneth Clarkson, Roger Miller and Timothy Murrs, "Liquidated Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach" (1977) 77 Columbia L. Rev. 351, 373.

[114] See, in the context of formalities, Lon L. Fuller, "Consideration and Form" (1941) 41 Columbia L. Rev. 799, 800-804.

[115] Patrick Mead, "Current Trends in Risk Allocation in Construction Projects and their Implications for Industry Participants" (2007) 23 Const. L.J. 23-45, 24.

[116] Ramy Zaghloul and Francis Hartman, "Construction contracts: the cost of mistrust" (2003) 21 I.J.P.M. 419-424, 420.

[117] Thompson, "A Fresh Look at Liquidated Damages" (2006) 22 Const. L.J. 289-306, 296.

[118] Mead, "Current Trends in Risk Allocation in Construction Projects and their Implications for Industry Participants" (2007) 23 Const. L.J. 23-45, 32; Bryan S. Shapiro, *Transferring Risks in Construction Contracts* (Shapiro Hankinson & Knutson, 2013), pp.7–8.

[119] Thompson, "A Fresh Look at Liquidated Damages" (2006) 22 Const. L.J. 289-306, 295.

a tender, which leads to "restricted bid competition"[120] and barriers to market entry.[121] Alternatively, contractors may take their chances and accept onerous LADs which they could never afford in reality.[122] This increases, inter alia, the risk of a breakdown of relationships during the project.

7) Further, the latter scenario could translate into the reduced "bankability" of projects (i.e. parties have difficulty satisfying funders/lenders), and/or the inability of contractors and subcontractors to "procure the requisite and appropriate insurance" (whether because insurers are wary or the costs of insurance become unbearable).[123] Ultimately, contractors and subcontractors could face higher risks of insolvency.[124]

V The way forward

In light of the new test in *Makdessi*, it is perhaps tempting at first sight for employers/developers to think that their "legitimate business interest" and the court's respect for the freedom of contract would always prevail,[125] and thus proceed to take a more ambitious approach when fixing the amount of LADs in the future. Indeed, one struggles to think of a situation in which an employer/developer cannot point to some legitimate interest (for example reputation, solvency and efficient allocation of resources between different projects) in the timely completion of a construction project, especially in PFI projects involving public welfare and taxpayers' money.

Nevertheless, given the potential problems identified in the preceding section, the author would make the following suggestions.

1) Parties should be careful not to assume that the court will necessarily take a much broader approach in countenancing arguments based on "legitimate interest". Indeed, it was stated in *Makdessi* that "[i]n the case of a straightforward damages clause, that interest will rarely extend beyond compensation for the breach, and we therefore expect that Lord Dunedin's four tests would usually be perfectly adequate to determine its validity".[126]

2) Further, the uncertainty of the new *Makdessi* test may well be mitigated by the fact that the Supreme Court regarded "unconscionable" as having the same meaning as "extravagant".[127]

[120] Zaghloul and Hartman, "Construction contracts: the cost of mistrust" (2003) 21 I.J.P.M. 419-424, 420.
[121] Thorpe, "Economists Divided—Different Perceptions of Contracts Penalty Doctrine" (1994) 6(2) Bond L.R. 189-209, 202.
[122] Hosie, "The assessment of damages for delay in construction contracts: liquidated and unliquidated damages" (1994) 10 Const. L.J. 214-224, 222.
[123] Mead, "Current Trends in Risk Allocation in Construction Projects and their Implications for Industry Participants" (2007) 23 Const. L.J. 23-45, 32.
[124] Thorpe, "Economists Divided—Different Perceptions of Contracts Penalty Doctrine" (1994) 6(2) Bond L.R. 189-209, 202.
[125] Lal, "Liquidated Damages" (2009) 25 Const. L.J. 569-590, 579.
[126] *Makdessi* [2016] A.C. 1172; [2016] B.L.R. 1 at [32], per Lord Neuberger and Lord Sumption. Lord Hodge at [255] took a similar view: "Where the test is to be applied to a clause fixing the level of damages to be paid on breach, an extravagant disproportion between the stipulated sum and the highest level of damages that could possibly arise from the breach would amount to a penalty and thus be unenforceable".
[127] *Makdessi* [2016] A.C. 1172; [2016] B.L.R. 1 at [31], per Lord Neuberger and Lord Sumption, at [152], per Lord Mance, and at [293], per Lord Toulson.

The enquiry is thus not so much on the fairness of a clause as its proportionality.

3) Therefore, when considering the amount of LADs, parties to a construction contract should always try to identify the risks and reach a fair and balanced allocation of risks when drafting liquidated damages clauses at the pre-contractual stage, recording the risks and costs in a risk allocation plan. The advantages are threefold: economic efficiencies can be maximised through sharing of risks; there is certainty as it would be difficult to dispute the arms-length bargain; and even if it comes to litigation, there is coherent evidence of the proportionality of the LADs.
4) In the case of projects involving additional non-financial interests which have to be safeguarded, employers should first consider using bonus payments and incentives for early completion coupled with project delivery mechanisms[128] to enhance cooperation and troubleshooting, rather than substantial LADs as a disincentive for delays.
5) If an employer does intend to deploy LADs as a deterrent, it should discuss the legitimate interests in question with the contractors at tender stage in order to explore risk-sharing and pricing options. A clear record of the interests discussed should be kept to avoid future disputes, and innovative drafting could extend to inserting bespoke warranties by the contractor.

So in the end, could Shylock be vindicated in the English courts? Quite unlikely, considering the kind of penalty he exerted. As the author has sought to demonstrate, however, the problem is that *Makdessi* has actually opened up the law to unsettling arguments of that sort. It is fanciful to think a contractor would be asked to pay with his pound of flesh, but if *Makdessi* means LADs in construction contracts could now be inflated to deter delays, it would be tantamount to Shylock's construction law—an undesirable position to take.

[128] Shapiro, *Transferring Risks in Construction Contracts* (Shapiro Hankinson & Knutson, 2013), pp.10–17.