When liquidated damages clauses are penalties: A kick in the teeth for PI insurers?

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Quick summary

- In the recent case of Grocon Constructors (QLD) Pty Ltd v Juniper Developer No. 2 Pty Ltd (Grocon Constructors) the Supreme Court looked at whether a liquidated damages (LDs) clause in a construction contract was a penalty.
- This decision is a useful whistle-stop tour of the key authorities on when LDs clauses are penalties.

Why should insurers care if LDs clauses are declared a penalty?

- If a LDs clause is declared a penalty, a party injured by delay can still pursue a common law action for delay damages (unless prevented by the construction contract terms).
- Some construction PI policies contain specific exclusions for LDs. However, if the PI policy LDs exclusion is narrowly worded, an insurer may still be obliged to indemnify an insured for common law delay damages liability (and such liability will not be caught by an assumed liability exclusion).
- If insurers want to exclude delay damages exposure completely, draft an exclusion clause that extends beyond merely excluding LDs and/or assumed liability.

What are LDs clauses?

LDs clauses are frequently used in commercial contracts to specify a pre-agreed compensation sum, which is payable once a breach occurs and without the need for loss to crystallise.

In construction contracts, LDs clauses provide a contractual remedy for construction delays. LDs clauses are popular in construction contracts for a number of reasons including, that they provide a quick and easy recourse for parties impacted by delay, they act as a cap on delay damages, and they provide a compelling deterrent for contractors to avoid delay.

However, LDs clauses are supposed to reflect the actual loss that will be suffered in the event delay occurs. It is well established law that if a LDs clause is not a "genuine covenanted pre-estimate of loss", it will constitute a penalty and be declared void and unenforceable.

Grocon Constructors - What happened?

In Grocon Constructors, the Supreme Court was asked to consider whether a LDs clause was a penalty. The Supreme Court held that the LDs clause in question was not a penalty. In reaching this decision, the Supreme Court re-visited previous key authorities which clarify that a LDs clause will constitute a penalty where damages payable under a LDs clause are demonstrated as extravagant, unconscionable, or disproportionate to the greatest conceivable loss that could flow from the breach (at the time the contract is agreed).

Whilst the case is a reminder that the Courts are reluctant to interfere with the contractual terms agreed by commercial parties, it remains the position that poorly crafted contractual LDs clauses could constitute a penalty and be declared void.

If a LDs clause is declared void, can delay damages still be recovered?

Generally, if a LDs clause is declared void, delay damages may still be recoverable at common law. However, some construction contracts contain...
“exclusive remedies” clauses which essentially provide that remedies under the contract exclude all other remedies at common law. This means that if a LDs clause is declared void, the contractor is left without a remedy for delay loss. Whilst the Courts require contractual wording to be very clear, if it is to remove such common law rights provided this requirement is complied with, an exclusive remedy clause can be relied upon.

In the absence of any exclusive remedy clause, a contractor is free to pursue its delay loss at common law if a contractual LDs clause is declared void. Whether such a clause is included in the contract and how strictly the clause is worded (i.e. the clause could be drafted such that it does not apply if a LDs clause is declared void) depends on the relative bargaining powers of the parties when negotiating the contract.

**Why should PI insurers care about whether LDs clauses are penalties?**

Many construction PI policies contain a specific exclusion for LDs liability incurred by an insured. However, if a LDs clause is declared a penalty and unenforceable, insurers should be aware that a LDs exclusion clause may not be drafted widely enough to exclude indemnity for a common law action for delay loss. Take for instance, a simple policy exclusion for LDs which excludes:

“liquidated damages for non-completion or delay in completion of any contract”.

This clause would clearly exclude cover for LDs but not common law delay damages. In this scenario, an insurer could be faced with not only indemnifying an insured for delay loss but also with indemnifying the insured for defence costs and costs liabilities to the claimant.

Further, any exclusion for liability assumed under contract (where such liability would not exist at common law) would also not be triggered where an insured faces a claim based on a common law liability for delay loss.

**Key points for PI insurers**

When drafting delay loss exclusion clauses, insurers should consider whether they intend to exclude or cover not only LDs liabilities but also common law delay damages liabilities, and draft the exclusion clause accordingly.

Whilst the Courts have been reluctant to void LDs clauses, this does not mean that it cannot happen. Delay liabilities can be significant and therefore insurers should draft their exclusion clauses with this in mind to avoid a “kick in the teeth” they were not expecting.