In the latest article in our Back to Basics series, we consider liquidated and ascertained damages (LADs) - what are they and why are they used? We also include some tips to consider when drafting a liquidated and ascertained damages provision into a construction contract.

**What are LADs and why are they used?**

To claim damages for a breach of contract, the party suffering the loss is required to prove various factors including the following:

1. that there has been a breach of contract;
2. that the breach caused its loss; and
3. the amount of the loss (having regard to its duty to mitigate).

Proceedings to ascertain these elements can be costly, time-consuming and damaging to commercial relationships. In certain types of contract, it is therefore common for the parties to agree up front what level of damages one party will be entitled to in the event the other party commits a specified breach of contract. This level of damages is referred to as liquidated and ascertained damages or "LADs" (or sometimes "LDs").

This alert is principally concerned with construction contracts, where the breach to which LADs
are most commonly applied is failure by the contractor to complete the works on time (although LADs can also be applied to other breaches, such as failure to meet specified performance targets).

The main benefits of LADs are that:

- they become payable upon the occurrence of the specified breach and the employer is not required to prove that it has suffered any loss;
- they provide commercial certainty for both parties and they effectively act as a cap on the contractor's liability for the specified breach;
- they reduce the need for costly and time-consuming court proceedings (or other dispute resolution mechanisms) to ascertain whether general damages are payable and the level of such damages; and
- they act as an incentive for the contractor to desist from committing the specified breach.

**Calculating the rate of LADs**

This section flags some key points to note when calculating the rate of LADs.

1. **Penalties**

If a LADs provision constitutes a penalty then it will be unenforceable. Since the case of Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd in 1915, a four-stage test has been applied when considering whether a LADs clause constitutes a penalty, with particular emphasis placed on the fourth limb, namely whether the sum payable in the event of a breach represents a genuine pre-estimate of loss.

While this is still a good rule of thumb or starting point, the more recent cases of Parkingeye v Beavis and Cavendish Square Holding BV v Talal El Makdessi have clarified the law on penalty clauses. See our previous alerts "Supreme Court judgment in ParkingEye Ltd v Beavis - beware overstaying your welcome in car parks" and "All change for penalties - or not? Implications of Cavendish v Makdessi for drafting" for further details.

2. **Backing off third party agreements**

In calculating the rate of LADs the employer should consider its potential liability to third parties pursuant to any third party agreements, such as agreements for lease or development agreements.

Having said that, it may not always be possible for employers to fully back off their potential
liability under third party agreements through the LADs, as the resulting rate of LADs may simply not be commercially acceptable to the contractor. For example, where an employer has entered into multiple agreements for lease with future tenants of a number of retail units in a new shopping centre and is liable to each future tenant for LADs for late completion of the units, the aggregate liability may be too great a risk for a contractor to accept.

3. Other considerations

From a contractor's point of view, the level of LADs should reflect any reduction that may be appropriate to account for reasonable steps the employer should be required to take in order to mitigate its loss.

Some drafting considerations

This section flags some key points to note when drafting a LADs provision into a construction contract.

1. Expressing the rate of LADs

LADs are most often expressed on a 'per day' or 'per week' basis, pro-rated in respect of any delay lasting part only of a day or week. However, in certain types of contract, such as contracts for works taking place on railways or motorways (or in other extremely time sensitive situations) LADs may be expressed on a 'per hour' basis.

However the rate of LADs is expressed, the mechanism for calculating the exact amount of LADs must be clear and unambiguous.

2. Caps on LADs

Sometimes the parties will agree to cap the contractor's liability for damages for late completion at a fixed sum or a percentage of the contract sum. This will be primarily a commercial consideration but, where a cap is included, consideration should be given as to what happens if the cap is reached. A common remedy is a right for the employer to terminate in these circumstances.

3. Don't state "nil" or "zero"

Where a standard form contract leaves a space for the rate of LADs to be inserted, the party putting the contract together may be tempted to insert "nil", "zero", "none" or "not applicable" in the relevant space. The unintended consequence of this can be that the contractor's liability for
damages for delay is zero.

If you are not utilising the LADs provisions in a standard form contract, or if LADs are being covered off by a separate mechanism in a schedule of amendments, then the whole of the obsolete provision in the standard form should be clearly deleted.

4. LADs "holiday"

You may come across references to a LADs "holiday" or a "LAD free period". This is essentially just a grace period during which the contractor has no liability for delay. For example, if the contractor has a two week LADs holiday, LADs will only begin accruing after the delay has continued for two weeks.

5. Sectional completion and partial possession

Where the contract provides for sectional completion, LADs need to be expressed as a rate per section and the rate of LADs for each section should reflect the likely loss the employer will suffer in the event of delayed completion of that section. Otherwise there is a risk that the LADs clause may fail for uncertainty.

In the event the employer intends to take partial possession of the works, the rate of LADs for delayed completion should be reduced accordingly in order to avoid the risk that the rate of LADs may be deemed to be a penalty or may fail for uncertainty.

6. Deducting and recovering LADs

Employers will want the right to deduct LADs from sums owed to the contractor under the contract but also the right to recover LADs as a debt, to cover the scenario where the contractor’s liability for LADs exceeds sums otherwise due to the contractor under the contract.

7. Make sure time does not become "at large"

In the event that time becomes "at large" under the contract (i.e. the contractor is no longer required to complete the works by a specific date but must complete them within a reasonable time) then a clause providing for LADs for late completion will fall away. In this scenario the employer will have to bring a claim for general damages at common law instead (unless the LADs clause is expressed to be the employer’s sole remedy in the event of delayed completion, in which case the employer may be left without a remedy at all).

Time may become "at large" where the employer has impeded or prevented the contractor from carrying out the works, for example by failing to give possession of the site, failing to provide
necessary instructions or information or obtain necessary consents, by varying the works or by physically interfering (or allowing third parties such as other contractors or tenants carrying out fit-out works to interfere) with the carrying out of the works. It is therefore crucial to ensure that the contract provides for the contractor to receive an extension of time in such circumstances.

8. Conditions precedent to claiming LADs

The parties should consider whether there are any particular requirements the employer will be required to comply with before being entitled to deduct or recover LADs, for example, the issue of notices (over and above those already required by statute).

Under the JCT Design & Build 2011 standard form (clauses 2.28 and 2.29) the employer may only deduct LADs after it has (1) issued a non-completion notice, (2) notified the contractor that it may require the payment of or may withhold or deduct LADs and (3) served a pay less notice not later than five days before the final date for payment.

The employer should ensure that any such requirements are complied with before seeking to deduct or recover LADs.

Practical considerations

LADs are frequently used as a stick with which to beat contractors but are not the only tool by which to seek to minimise delays. Other practical steps include:

- building appropriate buffers into the programme for the works;
- to consider including acceleration provisions to be exercised in the event the works are not proceeding as envisaged, or a bonus for the contractor for early completion; and
- ensuring the project is managed effectively so as to identify and address potential delays early on.