ICCP

Institute of Construction Claims Practicioners

Why and How Should You Substantiate Liquidated Damages for Delay?

INSTITUTE OF CONSTRUCTION CLAIMS PRACTITIONERS

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Why and how should you substantiate LDs for the delay?

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Whether to charge LD's for delay or not?

"If the Contractor fails to comply with Time for Completion, the Employer shall be entitled. . . to payment of Delay Damages . . ."

based on FIDIC

So straightforward!

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Whether to charge LD's for delay or not?

Plan:

- LDs charge impact to the Contractor,
- intentions behind LDs clauses,
- legal aspects as to LDs rate,
- methods to justify LDs rate,

feasibility of Time for Completion – beyond this lecture

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Contractor’s view

10% common CAP on LDs

5% need of working capital for project *(if 20 months and monthly Cash Conversion Cycle)*

CCC – period between suppliers payoff and income

Contractor’s view

10% at stake – if losses, then:

- **Interests (direct)**

- costly credit line,
- miss of other contract opportunities,
- delays on other contracts,
- bankrupcy…

Contractor's view

10% at stake – if losses, then:

- **Interests (direct)**

- costly credit line,
- miss other contract opportunities,
- delays on other contracts,
- bankrupcy…

Would these be considered indirects?

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Indirect risks

Willful misconduct – Might the Employer benefit from delays?

Gross negligence risks:

- Inexperienced management,
- Lack of EoT claims consideration,
- **Lack of consideration whether LDs are excessive,**

Poll

Should the careless charge of outrageous LD's for delays be considered as gross negligence?

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Should the careless charge of outrageous LDs for the delay be considered gross negligence?

Tylko Ty zobaczysz, jak inni głosują. **Więcej informacji**

Yes	63%
No	37%

278 głosów • Głosowanie zamknięte

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Intentions behind LDs

Extension damages:

- Overheads,
- **Loss of profit,** depend on future:
  - Demands,
  - Prices,
  - Costs.
- Goverment profits?

Uncertain, hard to prove.

LDs agreement:

The Employer – puts compensation on short notice,

The Contractor – limits risk (usually by fixing daily LD rate or having a CAP),

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Courts on LDs

“the mere availability of such a remedy would seriously jeopardize the stability and predictability of commercial transactions, so vital to the smooth and efficient operation of the modern . . . economy”

General Motors Co v. Piskor, 281 Md. 627, 381 A.2d 16 [1977]

“A term fixing unreasonably large liquidated damages is unenforceable on grounds of public policy.”

Space Master Int'l, Inc. v. City of Worcester, 940 F.2d 16, 18 (1st Cir.1991)

Whenever profit from LDs would exceed profits from completion, the Employer’s incentives would be against the purpose of the contract.

Threats are prohibited.

Courts on LDs

"A liquidated sum payable on a breach will not be held to be penalty unless it exceeds the greatest loss which would be predicted at time that the contract was entered into"

Dunlop Pneumatic Tyre Co Ltd v New Garage & Motor Co Ltd [1915] A.C. 79

PENALTIES > greatest foreseeable loss

Courts on LDs

*"There is **no valid justification** for the individual liquidated damage amounts contained in each of the three contracts. Under the record of this case, the **person who set the $400-per-day amount in each contract is unknown** and was not called as a witness. . . . Therefore, we conclude that the . . . liquidated damage clause . . . is an unrealistic amount and is therefore a penalty that should not be enforced"*

Rohlin Constr. Co. v. City of Hinton, 476 N.W.2d 78 (Iowa 1991)

PENALTIES are without justification

Courts on LDs

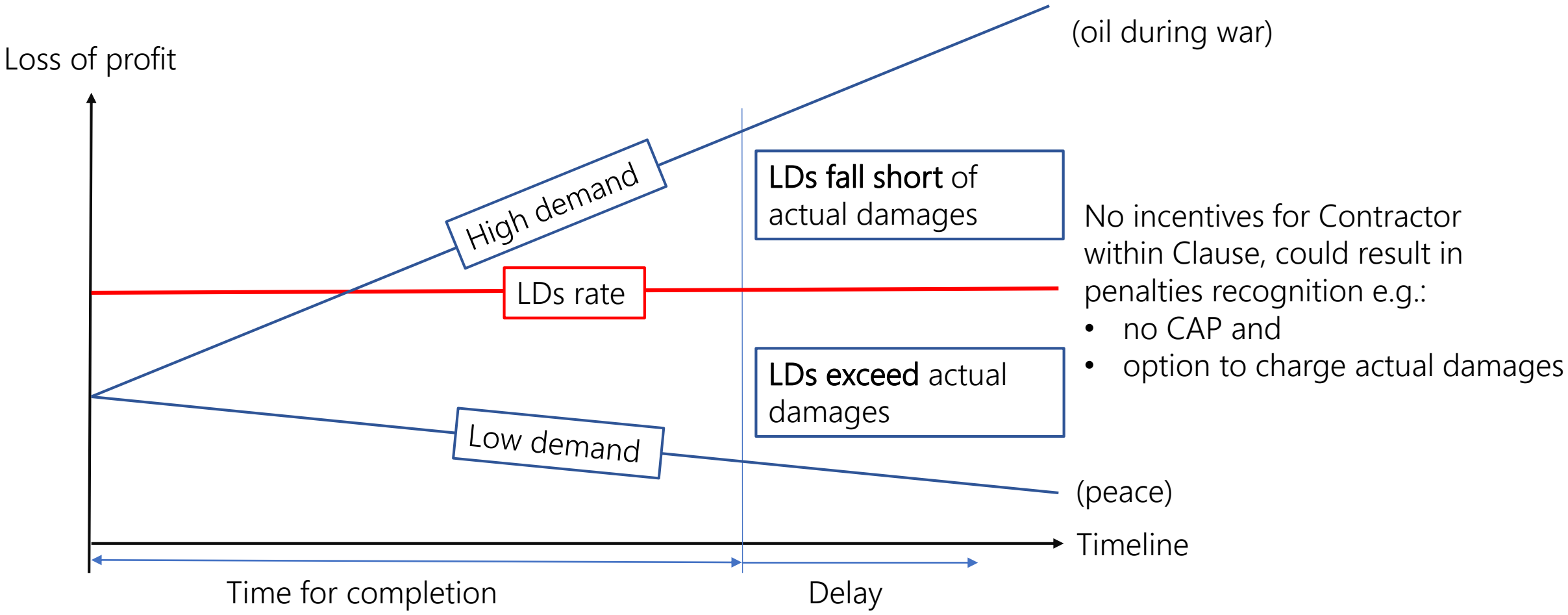
LDs are

"amounts fixed, settled and agreed upon in advance to avoid litigation as to damages actually sustained; ***they may exceed or fall short of the actual damages*** *sustained, but the sum thus fixed and determined [in advance] binds the parties to such agreement"*

Pacific Hardware & Steel Co. v. United States, 48 Ct. Cl. 399, 406 (1913)

LDs are to put compensation on short notice and do not depend on actual losses

LDs to FUTURE contract analogy



No incentives for Contractor within Clause, could result in penalties recognition e.g.:

- no CAP and
- option to charge actual damages

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Courts on LDs

"The importance of time as an element largely disappeared, and that practically no damage accured to the goverment on account of the failure of the company to deliver, cannot affect the meaning of this clause as used in the contract"

United States v. Bethlehem Steel Co., 205 U.S. 105 (1907)

else: Phillips (Hong Kong) Ltd v Att Gen of Hong Kong (1993) 61 B.L.T. 41

LDs does not depend on actual losses

Courts on LDs

“The debtor is liable for liquidated damages independent to whether the Creditor’s losses actually occurred.”

Polish High Court rule CZP 61/03 (self translation)

Do not confuse the term

ACTUAL LOSSES

with

PRE-ESTIMATED DAMAGES

Courts on LDs

“a single lump sum is made payable by way of compensation, on the occurence of one or more or all of several events, some of which may occasion serious and others but trifling damages”

Elphinstone v Monkland Iron and Coal Co (1886) 11 App Cas 332

else: Brecher v. Laikin 430 F. Supp. 103 (S.D.N.Y. 1977)

PENALTIES do not distinguish a default’s severity

Courts on LDs

Substantial completion doctrine.

Application of LDs depends on:

- Whether the owner is allowed to benefit from pre-occupied parts,
- To what extent the Owner is still exposed to the damages pre-estimated for LDs purpose,

LDs account for pre-occupation, substantial or sectional completion

Courts on LDs

"The record reflects this liquidated damages clause was not the subject of negotiation between the Railroad and S.O.G. It does not appear to be a bona fide attempt by both contracting parties to agree in advance on a reasonable forecast of just compensation for any harm which would be caused by delayed performance on the part of S.O.G.

The Railroad has not given any rational basis for its choice of $600.00 per day as damages for delay."

San Ore-Gardner v. Missouri Pacific Railroad company, 65 F.2d 562 (8th Cir. 1981)

The purpose of LDs explained by its literal wording was subsequently questioned.

Non-negotiated LDs are questionable.

Courts on LDs

Penalties

- Threats, deterrent, penal purposes of LDs are void,
- Penalties are over greatest forseeable loss,
- **Penalties have no justification**

Liquidated damages

- LDs do not have to correspond with actual losses
- LDs distinguish default serverity.
- LDs account for pre-occupation, sectional or substantial completion,
- **Non-negotiated LDs are questionable**

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How to justify LDs?

Example of investment valuation model.

Year	0	1	2	3	4	5	6 and beyond
Revenue		1 000	1 000	1 000	1 000	1 000	15 000
Operating expenses		700	700	700	700	700	10500
Operating income (EBITDA)		300	300	300	300	300	4500
Amortization (5%)		100	100	100	100	100	1500
Taxes		40	40	40	40	40	600
Net operating profit after taxes (NOPAT)		**160**	**160**	**160**	**160**	**160**	**2 400**
Contractor's salary	1600						
Management expenses	100						
Contingency	300						
Construction expenses	2 000						
Amortization		100	100	100	100	100	1 500
Net operating profit after taxes (NOPAT)		160	160	160	160	160	2 400
FCFF	**-2 000**	**260**	**260**	**260**	**260**	**260**	**3 900**
dFCFF (WACC 8%)	**-2 000**	**241**	**223**	**206**	**191**	**177**	**1 515**
NPV				**553**			

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How to justify LDs?

Method first (on basis of model):

- Use operating income as loss of profit,

$$\frac{Operating\ income\ /365}{Contractor's\ price} = \frac{300/365}{1600}$$

$$\approx 0.05\%\ daily$$

Year	0	1	2	3	4	5	6 and beyond
Revenue		1 000	1 000	1 000	1 000	1 000	15 000
Operating expenses		700	700	700	700	700	10500
Operating income (EBITDA)		300	300	300	300	300	4500
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How to justify LDs?

Method One:

- add extended overheads

$$\frac{Management\ expenses/365}{Contractor's\ price} = \frac{100/365}{1600}$$

$$\approx 0.02\%\ daily$$

- Total $\approx 0.07\%\ daily$

Year	0	1	2	3	4	5	6 and beyond
Revenue		1 000	1 000	1 000	1 000	1 000	15 000
Operating expenses		700	700	700	700	700	10500
Operating income (EBITDA)		300	300	300	300	300	4500
Amortization (5%)		100	100	100	100	100	1500
Taxes		40	40	40	40	40	600
Net operating profit after taxes (NOPAT)		**160**	**160**	**160**	**160**	**160**	**2 400**
Contractor's price	1600						
Management expenses	100						
Contingency	300						
Construction expenses	2 000						
Amortization		100	100	100	100	100	1 500
Net operating profit after taxes (NOPAT)		160	160	160	160	160	2 400
FCFF	**-2 000**	**260**	**260**	**260**	**260**	**260**	**3 900**
dFCFF (WACC 8%)	**-2 000**	**241**	**223**	**206**	**191**	**177**	**1 515**
NPV				**553**			

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How to justify LDs?

Method Two (prove that LDs could have been reasonable):

- **Assume 10- or 20-year payback period,**
- For WACC use debt cost and treasury bonds as equity cost, e.g. 3%
- Iterate until **NPV=0**

$$\frac{143/365}{1600} \approx 0.024\%\ daily$$

Benchmark

- **add extended overheads,**

Year	0	1	2	3	4	5	6 and beyond
Revenue							0
Operating expenses							0
Operating income (EBITDA)		143	143	143	143	143	2145
Amortization (5%)		100	100	100	100	100	1500
Taxes		8,6	8,6	8,6	8,6	8,6	129
Net operating profit after taxes (NOPAT)		**34**	**34**	**34**	**34**	**34**	**516**
Contractor's price	1600						
Management expenses	100						
Contingency	300						
Construction expenses	2 000						
Amortization		100	100	100	100	100	1 500
Net operating profit after taxes (NOPAT)		34	34	34	34	34	516
FCFF	**-2 000**	**134**	**134**	**134**	**134**	**134**	**2 016**
dFCFF (WACC 3%)	**-2 000**	**130**	**127**	**123**	**119**	**116**	**1 384**
NPV = 0				**0**			

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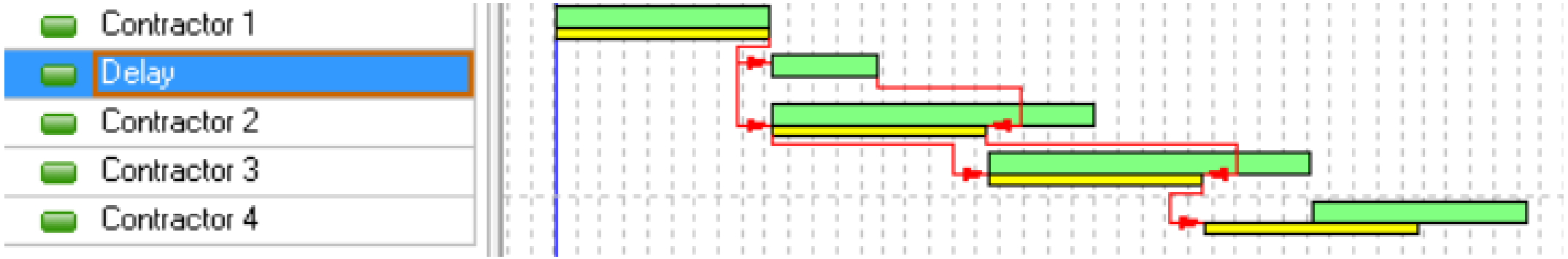
How to justify LDs?

Increase the LDs for the Contractors who could have an additional impact on others.



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Recommendations

- Check whether the LDs rate complies with invesment valuation model prior to contract conclusion
- Consider attaching valuation model to negotiations protocols,
- LDs are harmful for the Contractor,
  - Re-check whether LDs are substantiated prior to charge,
  - Consider EoT claims,
- Ask an expert if you are in doubt.

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Thank you!

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