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Constructive Notes ®

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Liquidated damages - are they always enforceable?

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The recent Supreme Court of Queensland decision of *Grocon Constructors (Qld) Pty Ltd v Juniper Developer No. 2 Pty Ltd* [2015] QSC 102 provides new authority on whether liquidated damages clauses constitute unenforceable penalties in construction contracts.

The decision is welcomed by those in the construction industry, who have been looking for industry specific guidance on liquidated damages clauses since the High Court considered penalty clauses in credit agreements in *Andrews v Australia & New Zealand Banking Group Ltd* (2012) 247 CLR 205. In *Andrews* the High Court found that late payment fees on particular credit accounts were a penalty, which arguably broadened the application of the penalty doctrine.

The facts

The matter concerned a mixed commercial development at Cavill Mall, Surfers Paradise (**Soul Project**). Juniper Developer No. 2 Pty Ltd (**Juniper**) engaged Grocon Constructors (Qld) Pty Ltd (**Grocon**) to undertake the design and construction for the Soul Project. The terms of the contract incorporated amended AS4300-1995 general conditions of contract for design and construct.

Grocon issued proceedings against Juniper claiming an amount of $10 million for work completed under the contract, prolongation costs, variations and interest. In the same proceedings Juniper counter-claimed for (amongst other things) liquidated damages owing under the contract, in the amount of $33.6 million.

The parties applied to the court for an early determination in relation to Junipers entitlement to make the liquidated damages claim.

At the centre of the dispute was the triggering of Grocon's liability for liquidated damages upon the failure to achieve Practical Completion by the date for Practical Completion. Under the contract Grocon was unable to obtain a certificate of practical completion until it had satisfied a number of specific requirements, some of which were, in the context of the project, relatively minor obligations, such as ensuring that keys for the works had '*approved label inserts*'. Failure to reach practical completion by the due date attracted scaled amounts of liquidated damages ranging from $14,750 to $49,000 per day.[1]

In its defence, Grocon alleged that the liquidated damages clause was unenforceable as it constituted a penalty.

Doctrine of penalties

A valid liquidated damages clause must be a *'genuine pre-estimate'* of the loss likely to be suffered by the relevant breach. The doctrine of penalties has its origins in English common law and serves to protect the legal principle that private punishment for breach of contract is unenforceable, and that pressure to perform a contract is an imposition on

an individual's liberty. Whether a liquidated damages clause in a contract constitutes a penalty has been the subject of significant judicial consideration.

The decision

In formulating his decision, his Honour Justice Lyons considered the linage of cases concerning the penalties doctrine both in Australia and the UK.

His Honour considered the relatively recent High Court decision of *Andrews v Australia and New Zealand Banking Group* (2012) 247 CLR 205, where the court had to consider the enforceability of various fees and charges imposed by the ANZ bank, including *'over limit'* fees which applied when a customer had overdrawn their account.

In *Andrews,* the court held that a stipulation imposes a penalty on a party (**first party**) if it is collateral to a primary stipulation in favour of a second party and this collateral stipulation, upon the failure of the primary stipulation, imposes upon the first party an additional detriment, the penalty, to the benefit of the second party. In *Andrews*, the late payment fees were found to be a penalty because they were payable on breach and were collateral to the main obligation; to pay the credit card bill on time.

It was Grocon's submission that, in the context of *Andrews*, achievement of Practical Completion was a primary stipulation, and the liquidated damages clause contained a collateral (or accessory) stipulation which imposed upon Grocon an additional or different liability, and accordingly the penalty doctrine was enlivened.

His Honour rejected Grocons submission, finding that the existence of collateral obligation was not sufficient to constitute a penalty, and the reference to *'additional detriment'* in *Andrews* is a reference to a detriment of greater magnitude or significance than the promisor would have suffered but for the penalty clause.[2] Accordingly his Honour's primary focus was on whether the collateral obligation was in the nature of a punishment.

There is a common law presumption that a liquidated damages clause is a penalty if it requires payment on the occurrence of one or more or all of several events, some of which may occasion serious and others but trifling damage.[3] His Honour found that the presumption did not arise on these facts as the clause was activated in only one way – a breach of Grocon's obligation to achieve Practical Completion by the Date for Practical Completion.

Finally, Grocon submitted the daily rate for liquidated damages was significantly disproportioinate to the damages that would be suffered for some trivial defects which would prevent Practical Completion, such as the failure to have an approved tag attached to one set of keys.[4]

His Honour held that the relevant breach was Grocon's failure to reach Practical Completion by the Date for Practical Completion. His Honour found that, irrespective of how minor the matter/defect may be acting to prevent Grocon from reaching Practical Completion, the fact that Practical Completion was not reached meant that Juniper would be prevented from taking possession and control of the site and settling contracts of sale with purchasers of units. It was not contested by Grocon that in such circumstances the liquidated damages clause would be disproportionate to the anticipated loss. Accordingly, the penalties doctrine did not act to void the liquidated damages clause.

Conclusion

This decision has come as a relief for many developers who have contracts on foot with similar worded liquidated damages clauses. The Supreme Court of Queensland has provided helpful industry specific guidance on the penalties doctrine and in doing so has reaffirmed the importance of the longstanding common law principle that liquidated damages must constitute genuine pre-estimate of a party's loss. To that end, a prescient statement appeared in the early stages of his Honour's judgment when considering the principles articulated by Lord Dunedin in Dunlop:

> *[58] In my respectful opinion, a critical statement by his Lordship is the statement that the essence of liquidated damages is that they are a genuine covenanted pre-estimate of damage.*

The decision has highlighted the importance of ensuring that the relevant liquidated damages clause is precise in its wording and requires payment on the occurrence of a specific breach, of a serious nature.

In calculating a genuine pre-estimate of a party's loss for the purpose of prescribing the rate for liquidated damages, a party is able to consider the greatest loss which the parties might have anticipated as flowing from the breach. To that end, it would be wise to include an acknowledgement in the liquidated damages clause that the rate prescribed is a genuine pre-estimate.

Further, in this decision, his Honour allowed extrinsic evidence (beyond the four concerns of the contract) to aid in determining the meaning of the liquidated damages clause. In doing so his Honour formed the view that both parties had agreed on the definition of Practical Completion, and negotiated the rates of liquidated damages. Accordingly, this decision also serves as a warning to ensure legal advice is sought on all provisions of the contract, and that any pre-contract/tender material (and in particular the bases on which the liquidated damages rate or amount was calculated) is maintained on file in the event that it may aid in interpreting the contract or determining if the rate of liquidated damages are penal in nature.

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[1] For Separable Portion 3 of the Contract.
[2] *Grocon Constructors (Qld) Pty Ltd v Juniper Developer No. 2 Pty Ltd* [2015] QSC 102 [70].
[3] *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd* [1914] UKHL 1.
[4] *Grocon Constructors (Qld) Pty Ltd v Juniper Developer No. 2 Pty Ltd* [2015] QSC 102 [31].

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When is a contract subject to contract?

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Most of us exchange many emails everyday in a casual manner. However, two recent decisions may cause you to re-think the contents of those emails. These two cases demonstrate that it is possible to form a contract through email communication without necessarily intending to be bound at the moment of despatch. Now is the time to review how you negotiate contracts and reconsider the language you use when doing so to ensure that you do not unknowingly enter into a binding contract.

In *Vantage Systems Pty Ltd v Priolo Corporation Pty Ltd* [2015] WASCA 21, an appeal from the District Court of Western Australia, the court considered whether an emailed offer and acceptance of terms was enough to establish that the parties intended to enter into a binding agreement to lease. The appellant was the lessee who contended that the primary judge had made an error of both law and fact. The lessee contended that an agreement to lease had not been formed as there had not been the necessary *'meeting of minds'* to infer there had been an agreement.

The Court of Appeal affirmed the trial judge's finding that there had been a concluded and binding agreement and that there was a sufficient meeting of minds to form a binding agreement. The appeal was dismissed.

Similarly in S*tellard Pty Ltd v North Queensland Fuel Pty Ltd* [2015] QSC 119, the Supreme Court of Queensland considered whether parties negotiating by way of email had entered into a binding contract for the purchase of freehold land and a business from the defendant. The plaintiff was the proposed purchaser of freehold land and a roadhouse business situated on that land. The defendant was the seller of the land and business.

The purchaser pleaded that an email exchange constituted a valid and binding agreement as informed by the conversations between the parties and the terms emailed between the parties. The court agreed with the purchaser and found that there had been a concluded and binding agreement.

The effect of *Vantage* and *Stellard*

The case of *Masters v Cameron*[1] was considered in both *Vantage* and *Stellard*. The principles of *Masters v Cameron*, as summarised in Halsbury's Laws of Australia, illustrate that where parties have reached agreement upon terms of a contractual nature, and also agree that the subject matter of their negotiation will be dealt with by a formal contract, the case may belong to any of three classes:

1. The parties have reached finality in arranging all the terms of their bargain and intend to be immediately bound to the performance of those terms, but at the same time, propose to have the terms restated in a form which will be fuller or more precise but not different in effect.

2. The parties have completely agreed upon all the terms of their bargain and intend no departure from or addition to that which their agreed terms express or imply, but nevertheless have made performance of one or more of the terms conditional upon the execution of a formal document.

3. The intention of the parties is not to make a concluded bargain at all, unless and until they execute a formal contract.[2]

The court in *Vantage* also considered what is commonly known as the fourth class of case in addition to those set out in *Masters v Cameron.* However, after some brief comments on the prior recognition of, and contention as to the necessity of, the fourth class, at [94] Buss J found it unnecessary to enter into a debate over it.

In both cases the courts found it apparent that the circumstances fell into the second class as specified in *Masters v Cameron*. All keys terms of the agreement had been agreed upon but the parties wanted to record the agreement in writing.

The courts in both *Vantage* and *Stellard* considered the intention of the parties objectively in accordance with the rule in *Ermogenous v Greek Orthodox Community of SA Inc*.[3] To that end, the courts considered the circumstantial evidence surrounding the negotiations in order to ascertain the objective intent of the parties.

In the case of *Stellard*, although subjectively it was clear that the seller was negotiating with other potential purchasers which evidences a clear lack of intent to be bound in contract to the purchaser, objectively, the language used by the seller to the purchaser and the apparent urgency[4] to get the contract finalised would imply to an objective observer that the parties had the intent to be bound.

The meaning of the words *'subject to contract'* included in the seller's acceptance email on 31 October 2014 was considered by the court in *Stellard*.[5] McHugh JA in *Baulkham Hills Private Hospital Pty Ltd v GR Securities Pty Ltd*,[6] to which the court in *Stellard* referred, said that parties may still be immediately bound to an agreement even when the parties agree that a formal contract is to be signed. The court in *Stellard* found that the use of those words, *'subject to contract',* needs to be measured against the relevant context and in this context, the court found that it strongly suggested that *'the parties were content to be bound immediately and exclusively'.*

In the case of *Vantage,* the court found 14 reasons as to why, objectively, there was a concluded agreement to lease. These reasons included the fact that the parties were already very familiar with each other commercially given that the lessor had been leasing the premises to the lessee for two years.[8]

In addition, the lessee was very familiar with the premises and knew of its suitability and capabilities since it had been leasing the property for six years.[9] Furthermore, the proposal encapsulated all of the terms necessary to form a contract.[10]

A further issue considered in both cases was the nature of the terms that were the subject of negotiations after the agreement became binding (as they were both found).[11] In both cases, the court considered that the specific terms that were to be negotiated after the agreement were not essential terms and continued negotiation on these terms is not inconsistent with an intention to the be bound. At [139] of *Vantage,* Buss JA stated:

> *'the subsequent negotiations, dealing and communications did not operate to rescind or otherwise discharge the earlier agreement'.*

Stellard also addressed the issue that legislation requires a transfer of land to be recorded in writing and signed by the person to be charged.[12] The court determined that the email sign off, in light of the conversations and other email correspondence, was sufficient proof of execution to satisfy the legislative requirements.[13] The application of the *Electronic Transactions (Queensland) Act 2001* (Qld), s 14(1)(c), was addressed by Martin J at [68] of *Stellard*:

> *'In circumstances where parties have engaged in negotiation by email and, in particular, where an offer is made by email, then it is open to the court to infer that consent has been given by conduct of the other party.'*

Practical considerations

In light of these two recent decisions, it is essential to assess what aspects of negotiations are reduced to writing in the negotiation process. If it is a party's intent to only become bound to contractual obligations that are contained in a formal contract, it would be prudent to limit the written negotiation of terms between the parties. Contract negotiations can take place by way of exchanging and amending formal contract documents rather than emails.

Furthermore, if parties are in or intend to be in negotiations with other potential co-parties, it would be prudent to either inform all tenderers that there are multiple tenderers or refrain from using terms such as *'offer'* and *'accept'* when in actual fact, you are simply *'considering'*.

The important message is that you do not need a physical, signed contract in order for there to be a binding agreement, even where legislation strictly requires the agreement to be recorded in writing, email communications may be sufficient. It is important to note that the determination of whether you intended to be bound by the emailed terms is an objective test. Therefore, regardless of what you may have intended at the time of sending an email, the objective assessment will be made on the basis of what is in the email and what an ordinary recipient may take the communication to mean. This objective assessment can also take into account any other communications you may have had with the other party.

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[1] (1954) 91 CLR 353.
[2] Lexis Nexis, Halsbury's Laws of Australia [110-530].
[3] (2002) 209 CLR 95.
[4] *Stellard Pty Ltd v North Queensland Fuel Pty Ltd* [2015] QSC 119 [40] and [41].
[5] Ibid [36].
[6] (1986) 40 NSWLR 631at 634.
[7] *Stellard Pty Ltd v North Queensland Fuel Pty Ltd* [2015] QSC 119 [39].
[8] *Vantage Systems Pty Ltd v Priolo Corporation Pty Ltd* [2015] WASCA 21 [120].
[9] Ibid [119].
[10] Ibid [123] and [136].
[11] *Stellard Pty Ltd v North Queensland Fuel Pty Ltd* [2015] QSC 119 [43] and *Vantage Systems Pty Ltd v Priolo Corporation Pty Ltd* [2015] WASCA 21 [136].
[12] *Property Law Act 1974* (Qld), s 59 and *Electronic Transactions (Queensland) Act 2001* (Qld), s 14.
[13] *Stellard Pty Ltd v North Queensland Fuel Pty Ltd* [2015] QSC 119 [67].

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