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Liquidated damages in energy projects

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In a noteworthy decision to participants in the energy industry, the High Court of England & Wales examined what constitutes a valid liquidated damages clause in the event of delayed completion of a solar project. And last week in Singapore, the High Court considered the enforceability of liquidated damages provisions on termination of power purchase agreements.

Construction projects, owing to scale and complexity, often find their timetables frustrated by unanticipated delays. These delays, if significant, can lead to considerable financial consequences. Because of this, it is imperative that employers include enforceable liquidated damages clauses in their contracts to protect their interests.

Ideally, a liquidated damages provision should seek to match the likely losses that an employer will incur or suffer in the event of late completion. Modelling such losses in advance is not always straightforward, particularly for energy projects where an employer's losses may be subject to a number of variables, including energy market conditions. If there is a significant mismatch between the liquidated damages payable and the employer's likely losses, there is a risk of the liquidated damages provision being held unenforceable as a "penalty". The law of penalties has undergone recent examination in a number of countries, and for energy projects the answer to the question of whether a provision is a penalty varies from jurisdiction to jurisdiction.

The recent case of *GPP Big Field LLP & Anor v Solar EPC Solutions SL* [2018] EWHC 2866 (Comm) ("**GPP v Solar**") merits the attention of employers and contractors engaged in renewable energy. The decision dealt with several legal issues, including the enforceability of liquidated damages clauses, which we consider here.

Background to the English case

GPP, the employer, and Prosolia UK, the contractor, entered into five EPC contracts for the development of five different solar power generation plants in the United Kingdom. Four out of the five developments failed to be commissioned by the relevant due dates, with the delays ranging from 44 to 285 days.

Among other claims, GPP, acting through its two investment vehicles, claimed liquidated damages of £500 per day in all four contracts for Prosolia UK's failure to achieve completion of the plants by the due date. The liquidated damages claimed amounted to £1,804,221 across the four delayed contracts.

Prosolia UK had become insolvent and was placed into liquidation in August 2015, so GPP sued Prosolia UK's parent company, Solar, as the guarantor and indemnifier of Prosolia UK's obligations under the four EPC contracts. Solar, alongside various other defences, raised the defence that the liquidated damages provision in each contract was a penalty, and therefore unenforceable against Solar.

Penalty or Liquidated Damages?

The court held that GPP was entitled to liquidated damages under all four of the EPC contracts, ruling that the provisions did not amount to unenforceable penalties in each of the contracts.

The court applied the test laid down by Lords Neuberger and Sumption in *Cavendish Square Holding BV v Talal El Makdessi* [2015] UKSC 67 ("**Makdessi**") to determine whether the damages clause was an unenforceable penalty:

"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…"

Neither party disputed that the clause created a secondary obligation that arose on the default of Prosolia UK's primary obligation to commission the plants by their respective due dates. However, the court found that the sum specified in the liquidated damages clause was not unconscionably disproportionate to GPP's legitimate commercial interest to ensure that the plants were operational on time.

In reaching the conclusion that the liquidated damages provisions were enforceable, the court also considered the earlier authority of *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd* [1915] AC 79 ("**Dunlop Pneumatic**"), and decided that the sum specified in the liquidated damages provisions did not exceed a genuine attempt to estimate in advance the loss which the claimant was likely to suffer from a breach, even though there was no clear evidence of how the parties had reached the liquidated damages figures ultimately agreed and inserted into the contract.

Generally, delay liquidated damages should be sized to cover the loss of revenue caused by a delay in commissioning the plant, and the subsequent delay in being able to sell electricity. The court noted that whilst the same daily sum was present across each contract, there was a 30% variance in the expected electricity prices recorded between the plants, and different outputs had been anticipated for each of the plants. However, the court held that even though actual losses from the failure to complete on time might vary, this did not mean that the liquidated damages for the contracts with smaller outputs or expected profits were necessarily penalties, provided that the liquidated damages were not extravagant and unconscionable in amount in comparison with the greatest loss that might have been expected, when the contract was made, to be likely to follow from the delay in completion.

The court also acknowledged that liquidated damages provisions are commonplace in construction contracts, and that the parties were both sophisticated entities, able to weigh up the commercial implications of the clauses. The court also considered the fact that the completion was due in mid-July - the peak generation period for photovoltaic installations in the UK - in deciding whether or not the rate of liquidated damages was "extravagant", and found that in these circumstances it was not. The references in parts of the contract to the liquidated damages being a "penalty" was also found not to be an equivocal indication of whether the provisions were indeed a penalty, but rather the court found that the substance of the matter needed to be considered.

Evolution of the penalty doctrine in Singapore

In another recent case, *Seraya Energy Pte Ltd v Denka Advantech Pte Ltd* [2019] SGHC 02, the High Court of Singapore also considered the issue of the enforceability of a liquidated damages regime in the context of energy projects. Amongst other issues, the court there was asked to decide whether a provision used in three similar power purchase agreements to impose liquidated damages on termination was an unenforceable penalty.

The court considered six recent cases where the High Court in Singapore had considered the test laid down by Lords Neuberger and Sumption in Makdessi and how, if at all, it was to be followed in Singapore. Ultimately, in the present case, the High Court came to the conclusion that the court was bound to follow the earlier case of Dunlop Pneumatic, and not Makdessi.

On the facts of the case, applying the test laid down in Dunlop Pneumatic, the court found that the liquidated damages provision in question was an unenforceable penalty.

This finding was based on a number of factors, including that:

- there was no evidence that the liquidated damages figure was a considered and genuine pre-estimate of the losses likely to be suffered by the generator on termination of the applicable power purchase agreement;

- one of the power purchase agreements allowed for termination for the generator's convenience, in which circumstance the liquidated damages were still purportedly payable by the customer;
- the same liquidated damages formula was included in each of the power purchase agreements, regardless of the terms or duration of the particular power purchase agreement;
- the generator was entitled to terminate the power purchase agreement for any breach of obligation by the customer, regardless of severity, potentially enabling the generator to terminate the power purchase agreement and claim liquidated damages even for minor breaches.

Looking at all the evidence holistically, the court found that the liquidated damages regime was included primarily to deter any breach by the customer, and was a penalty, which was therefore unenforceable.

While the court found that it was not bound to follow Makdessi, it did note that even if it were obliged to do so, in the present case it could not see any legitimate interest that would justify the generator imposing liquidated damages on termination at the proposed rate.

Comment

The *GPP v Solar* and *Seraya v Denka* cases highlight the importance of ensuring that a liquidated damages provision is enforceable, especially in "turnkey" construction contracts where timely completion of each stage of work is vital. Project owners should carefully consider the governing jurisdiction's law, and balance the need to encourage timely performance against the limits of the prevailing legal framework. Heavy financial penalties may be acceptable in some jurisdictions, but will be cast aside in others. As a general rule, it is often best practice to attempt to accurately estimate the expected loss, to lower the chance of a challenge to the validity of the clause which often means becoming embroiled in a costly dispute.

In *GPP v Solar*, there was no evidence presented to show the process the parties used to determine the reasonableness of the liquidated damages present in the contract. Though this was not a conclusive omission in this particular matter, in other cases, where the threshold for the voiding of a liquidated damages clause is lower, such records are of paramount importance in establishing that liquidated damages were set having regard to the actual losses that would be suffered for late completion.

The *Seraya v Denka* case, and the previous Singapore cases referred to in it, highlight the fact that the approach to the application of Makdessi and the penalty doctrine in common law jurisdictions outside of England and Wales is still very much an area where there may be further evolution.

Gerry Lianos (White & Case, Dubai) assisted in the development of this publication.

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