SPRING 2017 IN SITE

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Construction and Engineering Newsletter

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Welcome to the Spring edition of "In Site". This edition provides an update on the recent amendments to the JCT and FIDIC standard forms of contract and considers the new SCL Delay and Disruption Protocol.

We also consider the recent case of V*ivienne Westwood Ltd v Conduit Street Development Ltd* [2017] EWHC 350 (Ch) which serves as a useful reminder of the test for penalty clauses and set out some practical tips to avoid such clauses being treated by the courts as non-compliant and unenforceable.

BE PREPARED - NEC4 IS COMING

Evolution Not Revolution

The NEC4 suite of contracts will be published on 22 June 2017. The NEC has described the new contracts as an "evolution not revolution" of NEC3 and we hope you are able to attend our seminar on 5 July 2017 to learn about the detail of the changes - invitations will be issued shortly.

JCT 2016: Amendments to the JCT suite of contracts

Following industry wide consultations, the JCT began to publish an updated suite of contract documents in the latter half of 2016. The risk allocation between the parties has not changed; the aim of the newest contracts is to consolidate the updates and supplements released since the 2011 editions and to ensure that they are in line with current market practice and legislation.

2016 Suite of Documents

New editions are available for the following contract documents:

- Standard Building Contract
- Design and Build Contract
- Major Project Construction Contract
- Intermediate Building Contract
- Minor Works Contract
- Contractor/Sub-Contractor Collateral Warranty in favour of a Purchaser/Tenant/Funder
- Short Form of Sub-Contract

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The JCT is set to publish new editions of other contracts in its suite of standard forms during the course of this year.

Key Changes

The changes introduced are largely the same across the 2016 suite and include a mixture of statutory updates and changes to reflect current initiatives. They key ones to note are as follows:

CDM Regulations - The suite incorporates the changes under the CDM Regulations 2015. These changes were previously included in separate amendment sheets from March 2015.

BIM - Specific contract options in relation to BIM and its use in projects have been introduced.

Public Contracts Regulations - The 2016 suite includes provisions for use by Employers (including public bodies and housing associations) which are covered by the Public Contracts Regulations 2015. These changes reflect the amendments relating to termination and payment already in use by these bodies.

Payment - Payment provisions provide the greatest change from the 2011 editions. These include establishing, for Fair Payment purposes, Interim Valuation Dates which will operate at main contract, sub-contract and sub-sub-contract levels. Interim Payments are now linked to a new Interim Valuation Date and do not need to be listed in a payment schedule.

Payment provisions have also been simplified with new procedures for assessing loss and expense claims, and a new requirement that such assessment must be conducted promptly.

Security Documents - The 2016 suite includes provisions for the Contractor to provide Performance Bonds and Parent Company Guarantees as this is already common practice. However, the new suite does not include a standard form Bond or Guarantee.

Insurance - A longstanding criticism of the JCT forms was that, where the works related to existing structures, "Option C" insurance (insurance by the Employer of existing structures and works to them) assumed that the Employer controlled the relevant buildings insurance for those structures. This was clearly not always the case. The changes to the insurance provisions allow insurance of the works and existing structures by other means and therefore give the parties greater flexibility to tailor the provisions to their own requirements.

Loss and Expense - Claims or potential claims are now to be notified at the earliest opportunity along with monthly updates from the Contractor. The Contract Administrator (or equivalent) is required to make an assessment of the claim within 28 days of receipt of the claim and within 14 days of receipt of any subsequent update; under the JCT 2011, there were no such deadlines.

Amendments to the FIDIC White and Yellow Books

The FIDIC suite of contracts, the most popular forms for international construction and infrastructure projects, is also going through a period of significant update.

A pre-release version of the Yellow Book (Plant and Design-Build) has been issued, and similarly amended versions of the other main construction forms, including the Red Book (for Building and Engineering Works) and the Silver Book (EPC/Turnkey Projects) are also in the pipeline.

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FIDIC has also just published the 2017 edition of the consultant's appointment form, known as the "White Book", and entirely new forms (including sector-specific tunneling and renewables forms) are also expected during the course of the next 2 years.

Based on what we have seen to date with the Yellow Book there are a number of emerging themes which we may expect to flow through the remaining new forms. Very briefly, these include:

- extensive changes, both in terms of length and effect;
- a tighter and more streamlined approach to definitions and general structure;
- additional and/or more onerous obligations on the Engineer, and greater detail in relation to the role of the Engineer in arriving at determinations. The Engineer is required to act "neutrally between the Parties" when carrying out his duties under the agreement or determination provisions. The word neutral is not defined and may be a fruitful area of debate;
- the inclusion of additional/improved project management tools, including expanded programming obligations, and the inclusion of "NEC style" concepts, such as advance warnings;
- inclusion of concurrency provisions in the extensions of time clause;
- improved clarity in the Variation procedure and considerably greater detail, including enabling the Engineer to request a proposal prior to instructing a Variation;
- a tightening of the payment provisions, particularly in terms of content of the Contractor's application;
- an enhancement of the performance security provisions, with provision for the value of the performance security to track significant changes in the Contract Sum;
- inclusion of an additional "carve out" to the limitations on the Contractor's liability (in Sub-Clause 17.6) i.e. a new indemnity from the Contractor in relation to "any errors in the design of the works and other professional services which results in the works not being fit for purpose" which may mean that Contractors are exposed to unlimited liability for fitness for purpose;
- an overhaul of the claims provisions: instead of individual clause provisions for Employer claims (former Sub-Clause 2.5) and Contractor claims (former Sub-Clause 20.1), these have now been merged together within an enlarged Sub-Clause 20.1 and 20.2 and with both parties now subject to the same time bars for making a claim;
- the time bars and preliminary notice provisions are subject to a new Sub-Clause 20.3, "Waiver of Time-limits", which builds on the approach in the Gold Book of giving the Dispute Adjudication Board (DAB) the right to override the time bar; and
- Sub-Clause 21 now includes a requirement for a standing DAB (not ad hoc) and the DAB has been integrated into the escalating claims resolution procedure.

In conclusion, some of the most important changes appear to be practical, in particular the update to the claims provisions which will encourage faster dispute resolution. However, some areas of the "special pre-release

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version" of the Yellow Book are likely to generate debate and may be the focus of negotiation and amendment by contracting parties.

The increased prevalence of time bars, together with the greater complexity of the claims procedure and notification requirements and the greater integration of the DAB into the claims procedure, are likely to make the "new" Yellow Book much more "resource hungry" in terms of administration for all parties, and particularly the Engineer. They may also increase the number of claims as Parties notify and submit claims to avoid the time bars and refer disputes over time bars to the DAB. This will no doubt be an area of debate: some may see this as an unnecessary additional burden on the project and a distraction from the overriding objective of progressing the works, whereas others may see it as necessary to allow disputes to be resolved as and when they arise and avoid claims rolling up into more significant disputes.

Detailed analysis of the key changes made to the Yellow Book can be found here.

2nd Edition SCL Delay and Disruption Protocol Published

The purpose of the Protocol is to provide guidance in resolving common delay and disruption issues on construction projects, hopefully avoiding unnecessary and costly disputes. It has been under review since it was first published in 2002 due to developments in the law and construction industry practices, both domestic and international and the publication, in February 2017, of the 2nd Edition of the Protocol represents the culmination of that process.

The key changes relate to the issues of extensions of time and delay analysis methodology.

Extensions of Time (EOT) - It was strongly suggested during the review of the 1st Edition of the Protocol that contemporaneously submitting and assessing an EOT application and the subsequent award of an EOT can lead to unrealistic results if it transpires that the EOT claimed is significantly more than the delaying event for which the employer accepts risk.

Essentially it was thought during the review process that clarity was of greater value than a "wait and see approach". The contemporaneous submission and assessment of an EOT application was elevated to a core principle to allow appropriate mitigation measures to be considered by the project participants to limit the impact of the delay event.

This is very much in line with, for example, the JCT 2016 editions which require the prompt notification and assessment of matters which are likely to affect the regular progress of the works.

Delay Analysis Methodology - A key difference in the 2nd Edition is the removal of the preference for a particular delay analysis methodology. The reasoning for this change is that the contract terms, the circumstances of the project and the available project records are all crucial factors in determining the most appropriate methodology and these matters will vary between projects. Instead of providing a preference, the Protocol identifies the factors that ought to be taken into account when selecting the most appropriate methodology.

Whilst the Protocol is a useful tool for parties to a construction project, it is not a contract document and must therefore not take precedence over the agreed contractual terms.

Penalty clauses

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Vivienne Westwood Ltd v Conduit Street Development Ltd [2017] EWHC 350 (Ch)

Clauses which specify that sums are to be paid out upon breach of a contractual provision are common in commercial (and particularly construction) contracts. However, if such a clause is found to be a penalty, the claimant cannot claim more than its actual loss.

The 2015 case of *Cavendish Square Holdings BV v Talal El Makdessi and ParkingEye Limited v Beavis* represented a major shift in the focus for identifying penalty clauses. In a combined appeal relating to whether certain contractual clauses were unenforceable penalties, the Supreme Court upheld the rule against penalty clauses but re-focused and clarified the test for identifying one.

Previously the penalty rule referred to a "genuine pre-estimate" of damage or loss (originating from the well-known *Dunlop* case decided by the House of Lords in 1914). However, in considering the appeals in *Makdessi and ParkingEye* it was noted by the Supreme Court that the tests in *Dunlop* were originally proposed "*not as rules but only as considerations which might be helpful"* and may still be useful for simple payment of damages clauses. The court in *Makdessi* distinguished between "primary" obligations which are required to be performed under the contract and "secondary" obligations which are triggered by a breach.

The court confirmed that "*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."*

The recent High Court decision in the *Vivienne Westwood* case, upholding the principles in *Makdessi*, is a useful reminder of the test for determining whether or not a clause is a penalty (and hence unenforceable).

The court was required to interpret a side letter to a lease concerning a rent concession. The side letter provided that if the tenant breached its terms, or those of the lease, it would need to pay the higher rent contained in the lease, on a retrospective basis.

The tenant took a 15 year lease form the landlord, at an initial rent of £110,000 per year, subject to reviews in the fifth and tenth years. The side letter was entered at the same time and provided that the landlord would accept a lower rate of rent: increasing from £90,000 in the first year to £100,000 for the fifth year and would be capped at £125,000 per year for the following five years if a higher open market rent was determined upon the first rent review.

In time, the tenant failed to pay the rent, and the landlord alleged that the side letter had been terminated and therefore open market rent was payable. The issue to be decided was whether the terms of the side letter imposing the higher rent constituted a penalty and were unenforceable.

In applying *Makdessi* it was necessary to determine firstly whether the provision in question was a primary obligation or a secondary one (which was only activated upon the breach of a primary contractual one). In this case, the primary obligation was to pay rent at a reduced rate unless there was a breach of contract in which case a secondary obligation (to pay a higher rent) kicked in. The rent could be increased if the tenant breached any of its obligations, regardless of the nature or severity of the breach.

Given that the clause in question (the payment of a higher rent) was a secondary obligation, in order to establish whether or not it was a penalty it was necessary to consider the extent to which the "innocent" party had a

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legitimate interest in having the primary obligation enforced and whether or not the payment required under the secondary obligation was extravagant or unconscionable.

It was held that the reduction in rent was a fundamental part of the bargain struck between the parties and the landlord, therefore, was unable to argue that it had a legitimate interest in the rent reverting to the open market level. The fact that the obligation to pay the higher rent applied regardless of the nature of the breach or consequences for the landlord, was indicative of a penalty. It was held that the obligation to pay rent at a higher rate from the rent commencement date of the lease was penal in nature (even if it had only prospective effect). It might give rise to a very substantial and disproportionate financial detriment which seemed exorbitant and unconscionable in comparison with any legitimate interest in full performance. The termination of the side letter was therefore unenforceable.

This approach to penalty clauses was also confirmed by the Court of Appeal in the case of *Edgeworth Capital (Luxembourg) S.A.R.L and Aabar Block S.A.R.L v Ramblas Investments B.V.* [2016] EWCA Civ 412. It was held that a fee falling due to Edgeworth under a loan agreement was not a penalty clause even where the fee appeared excessive. The defendant disputed that a €100 million fee was a "Payment Event" under one contract, triggered by a default under another contract. At both first instance and on appeal, the court found that the rules on penalties were not triggered. The fee had nothing to do with damages for breach of contract: it was payable on the happening of a specified event and accordingly didn't fall foul of the rule against penalties. Interestingly though, both courts referred to the recitals of the relevant contract which expressly stated that it was appropriate that Edgeworth should be entitled to the fees as set out therein. This is a further reminder of the need to ensure that recitals are carefully drafted as the courts may well refer to them when considering a dispute.

Practical tips to avoid penalty clauses

In light of these recent cases, contract drafters may wish to consider (along with specific legal advice on a particular matter) the following to maximise the chances of such clauses being upheld:

- the rule against penalties will only bite with respect to secondary obligations (although it can also potentially apply to clauses which provide for the retention or withholding of sums for non-performance). Therefore, if possible, payment should be framed as a condition of compliance (hence a primary obligation);
- although the Supreme Court in *Makdessi* said that the real question is whether a clause is penal, not if it is a pre-estimate of loss, if a liquidated damages clause does amount to a genuine pre-estimate then it is more likely to be enforceable. As the court commented, the innocent party's interest will rarely extend beyond compensation for the breach;
- a key consideration is whether there is a "legitimate interest" that goes beyond damages for breach of contract. It would therefore be worth including express wording setting out the interests that the parties are seeking to protect; the contract's recitals is a good place;
- the enforceability of the clause depends on whether it is unconscionable or extravagant so the detriment imposed must be proportionate to the interest the party is seeking to protect. It is advisable to consider this at the drafting stage and try to anticipate how it would be viewed if scrutinized at a later date. Although describing a provision as a deterrent does not on its own mean the clause is inherently penal, a clause which sets out to punish the defaulting party runs a higher risk of being unenforceable;

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- consider whether the consequences of a breach take effect regardless of its nature and/or whether they have retrospective effect. Although not necessarily determining factors, they may point to the fact that a provision is penal; and
- the initial presumption is that the parties are best judges of what is legitimate in a provision dealing with the consequences of a breach. The contract drafter may therefore wish to include express wording that agreement has been reached between the parties on equal terms with the benefit of professional advice.

For more information on any of these articles, or on any other issue relating to construction and engineering law, please contact any of the authors or your usual K&L Gates' contact.

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