

BASIS IN ASCERTAINING THE AMOUNT OF LIQUIDATED DAMAGES

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Specially dedicated to *Mak* and *Ayah*
Terima Kasih.

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ABSTRACT

In Malaysian construction industry, one of the conditions in the contract made between the employer and contractor is to complete a project within a specified time. Failure to fulfil the condition will amount to breach of contract. Main remedy available for breach of contract is an award of damages. Damages are a reasonable sum of money awarded as compensation to the innocent party and one of the damages available is liquidated damages. It is a genuine pre-estimate amount and provided not to penalise the party at fault. A building owner will want to claim as much as he can to cover the loss resulted from the delay of completion. The objectives of this research are to identify the basis in ascertaining the amount of liquidated damages and ascertain whether the amount of liquidated damages is a reasonable compensation or not. There are elements of cost from nine articles tabulated in a table to create a basis in ascertaining the liquidated damages amount. Twenty elements of cost found and they were divided into major and minor costs. There are seven elements under the major cost and the rest were classified as minor cost. The major costs are financing interest, loss of profit, professional fee, administrative cost, alternative facilities, supervision fees and overhead. Three public projects and two private projects were analysed to ascertain whether the amount of liquidated damages were reasonable or not. As a result, the amount of liquidated damages in public project appears to be reasonable as it is less than the amount of losses suffered. In private projects, the amount of liquidated damages is unreasonable as the amount is more than the losses suffered and can be challenged as penalty by the contractor.

ABSTRAK

Perjanjian dalam kontrak pembinaan di Malaysia diantara klien dan kontraktor telah menetapkan syarat bahawa sesuatu kerja hendaklah disiapkan dalam tempoh masa yang ditetapkan. Kegagalan kontraktor menyiapkan projek dalam tempoh masa yang dipersetujui akan mengakibatkan kemungkiran kontrak. Remedi utama kemungkiran kontrak ialah pemberian pampasan. Pampasan dalam konteks pembinaan merujuk kepada sejumlah wang yang berpatutan kepada pihak yang menanggung kerugian iaitu, klien. Ganti Rugi yang Ditetapkan (LAD) ialah salah satu jenis pampasan. Ianya tidak bertujuan untuk mendenda pihak yang mungkir dan dianggap sebagai jumlah anggaran sebenar yang ditetapkan dalam kontrak. Pemilik bangunan kebiasaannya mahukan tuntutan kerugian mereka meliputi keseluruhan kerugian yang dialami akibat daripada kemungkiran kontrak tersebut. Objektif kajian ini adalah untuk mengenalpasti asas penentuan jumlah LAD dan menentukan sama ada jumlah LAD yang telah dipersetujui merupakan jumlah ganti rugi yang munasabah atau tidak. Elemen-elemen kos dari sembilan artikel telah dikumpul dan dikenalpasti. Sebanyak dua puluh elemen kos dikenalpasti dan di kategorikan sebagai kos utama dan kos sampingan. Terdapat tujuh elemen kos yang diklasifikasikan sebagai kos-kos utama manakala yang selebihnya adalah kos-kos sampingan yang perlu diambilkira. Kos-kos utama tersebut adalah pembiayaan, kerugian, fi professional, kos pengurusan, kemudahan alternatif dan overhead. Tiga projek kerajaan dan dua projek swasta kemudiannya dianalisis untuk menentukan sama ada jumlah LAD yang dipersetujui adalah munasabah. Di akhir analisis, jumlah LAD projek kerajaan adalah munasabah kerana jumlah LAD-nya kurang dari kerugian yang dialami klien. Manakala projek swasta menunjukkan hasil yang sebaliknya dan jumlah LAD tersebut berpotensi untuk dicabar oleh kontraktor.

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CHAPTER 1

INTRODUCTION

1.1 Background of the research

Contract is an agreement enforceable by law.¹ Contract sets out roles and responsibilities of the contracting parties. When there is a contract in construction, the employer and contractor are agreed to fulfil their obligation within the terms and condition lined. It is usual for the parties to enter into contract on the basis that the works are to be completed by a particular date (or dates) that is (or are) agreed. (O'Neill, 2008)

¹ Section 2(h) Contract Act 1950

A breach of contract may be a partial or complete failure to perform, delayed performance, faulty or inadequate performance. (Oon, 2005). In Malaysian construction industry, 17.3% of construction projects experience more than 3 months delay and some of them are abandoned. (Azlan, et al., 2010)

Most employers, in particular the developers, forecast their profitability placing reliance on completion of their projects by the contractor in accordance with the planned schedule. (Lim, 1993). Additional project expenses incurred by the owner resulting from project dedicated forces and resources utilized beyond the expected contractual completion date. (Crowley, et al., 2008)

Construction owner also suffer additional costs when project completion is delayed, such as loss of income or profit, loss of rental or usable value of the property, increased financing costs, including interest on a construction loan, extended maintenance and operation expenses and additional consultant fees. (The University of Texas School of Law, 2011). When there is delay in project completion, the owner can be harmed by added cost and loss of revenue. (Thomas, et al., 1995)

Failure by one of the parties to execute his obligation, in this case is delivering the project within the stipulated time will trigger a breach. The innocent party is entitled to one or more of the telling remedies: (Singhs, 2011)

- (1) rescission of contract,
- (2) damages,
- (3) specific performance and
- (4) injunction. (Singhs, 2011).

The main remedy available for breach of contract is an award of damages. (DTM Legal, 2012)

Damages are a sum of money awarded by a court as a compensation for a tort or a breach of contract. (Law, et al., 2009) Damages are assessed with the intention of making the innocent party's position (so far as money can do this) equivalent to what would have been *if the contract had been properly performed*. (Murdoch, et al., 2008) This principle was reiterated from the case of *Robinson v Harmon*² :

... the innocent party is entitled to be placed so far as money can do it, in the same position as he would have been had the contract been performed...

Damages may also be claimed under the principle established in the case of *Hadley v Baxendale*³ comprises of two main limbs, i.e:

- (a) The first limb: damages arising naturally or also called as direct damage

- (b) The second limb: damages as may reasonably be supposed to have been in contemplation of both parties at the time they made the contract and referred as indirect or consequential loss.

² [1848] 1 Exch 850 at p 855

³ [1854] EWHC J70

Malaysian Law⁴ has codified the above rule which reads:

- (1) When a contract has been broken, the party who suffers by the breach is entitled to receive, from the party who has broken the contract, compensation for any loss or damage caused to him thereby, which naturally arose in the usual course of things from the breach, or which the parties know, when they made the contract, to be likely to result from the breach of it
- (2) Such compensation is not to be given for any remote and indirect loss or damage sustained by reason of the breach

There are several types of damages cited by Singh (2011) and LaMance (2013) available for breach of contract, namely:

- (a) General damages
 - Damage that are not specifically pleaded, assessed and awarded by court
- (b) Compensatory/Substantial damages
 - A pecuniary compensation for the loss actually sustained and most common form of damages.
 - It compensates the non-breaching party whole again
- (c) Nominal damages
 - Awarded when there is a technical breach but no loss arises and always in a form of derisory sum

⁴ Section 74(1) & (2) Contract Act 1950

(d) Liquidated damages

- Agreed and ascertained amount at the time contract was made and expressly stipulated in contract.

(e) Unliquidated damages

- Unascertained amount that need to be proved and dependent on the circumstances of the case.

(f) Punitive/Exemplary damages

- Vindictive in nature and far greater than the actual loss sustained.
- Intended to punish the breaching party and deter them from committing future breaches

(g) Special damages

- A kind of damage which the law will not presume in the innocent's party favour, but which specifically pleaded and proved at the trial or arbitration hearing such as loss of profit and interest on money.

In construction industry, the remedy obtainable for delays on project delivery is liquidated damages. (Bello, 2010). Liquidated damages can only be claimed if there is an expressed provision in the contractual document. It was stated that the provision made in the contract usually will practice the win-win formula for both parties. The provisions also furnish a relatively simple contractual mechanism for compensating the employer for the financial consequences of the contractor's breach.

Harban Singh (2011) in his book stated that liquidated damages are damages agreed between the parties at the time of contracting and stated in the contract as a damages payable in the event of a specified breach, usually that of late completion. The

sum must be genuine pre-estimate of the loss likely to be caused by the breach of a lesser sum. Liquidated damages are one of the recovery forms of damages and often misconstrued to the penalty (Lim, 1993).

In construction, the sum of liquidated damages has been agreed at the very beginning of the contract, in the letter of award. The normal provision of construction contract⁵ state that there is no need for the employer (innocent party) to prove his loss. The contractor may put up an effort of proving the pre-estimate amount is wrong and come out with new amount which may benefit the contractor in such a way lesser. However, these provisions contradict to the principles spell out in the Contract Act 1950.

As liquidated damages is often misconstrued to be as penalty, it is crucial to differentiate the provisions in order to keep it enforceable. The Malaysian leading case of liquidated damages, *Selva Kumar Murugiah v Thiagamjah Retnasamy*,⁶ provides that the employer must prove his actual loss in line with the provision in the Contract Act:

⁵ **PAM 2006 Clause 22.2** The Liquidated Damages stated in the Appendix is a genuine pre-estimate of the loss and /or damage which the employer will suffer in the event that the contractor is in breach of Clause 21.0 and 22.0. The parties agree that by entering into the contract, the contractor shall pay to the employer the said amount, if the same become due without the need for the employer to prove his loss and/or damage unless the contrary is proven by the contractor.

PWD Form 203A (Rev1/2010) Clause 40.3 The liquidated Damages stated in Appendix 1 shall be deemed to be a reasonable amount of loss which the Government will suffer in the event that the contractor is in breach of this clause. The contractor by entering in to this contract agrees to pay the Government the said amount(s) if the same become due without the need of the Government to prove his actual damage or loss.

⁶ [1995] 1 MLJ 817

Section 75

*“When a contract has been broken, if a sum is named in the contract as the amount to be paid in case of such breach, or if the contract contains any other stipulation by way of penalty, the party complaining of the breach is entitled, **whether or not actual damage or loss is proved to have been caused thereby**, to receive from the party who has broken the contract reasonable compensation not exceeding the amount so named or, as the case may be, the penalty stipulated for”*

This principle was further reaffirmed in the case of *Johor Coastal Development Sdn Bhd v Constrajaya Sdn Bhd*.⁷ Judge Ariffin Zakaria stated that Section 75 of the Contract Act shall stay governed and court must determine what is the reasonable amount of compensation. In another case of *Setegap Bhd v Ranhill Engineers and Constructors Sdn Bhd*⁸, court refused to grant the amount of liquidated damages claimed by defendant as they failed to prove the amount. However, in between the two cases, Judge Abdul Aziz Mohammed made a different verdict in the case of *Sakinas Sdn Bhd v Sie Yik Hau & Anor*.⁹ He decided that the latter did not require proof of actual damage or loss because there was no known measure of damages employable.

The main thing in proving liquidated damages amount is to make sure that the amount provided is a reasonable compensation to the innocent party and not to penalise the party at fault. Penalty will cause the contract unenforceable and void. A solid and accurate amount of liquidated damages is crucial and can be served as a proving mechanism of the “loss” suffered by the employer.

⁷ [2009] 4 MLJ 445

⁸ [2011] 6 MLJ 684

⁹ [2002] 2 AMR 1953

There are many ways of ascertaining/calculating liquidated damages amount. In public projects, the employer uses base lending rate as a basis of calculating. Eggleston (2009) in his book percentage out certain portion of the contract sums to come out with the amount of liquidated damages. Employer should have a basis in ascertaining the amount of liquidated damages as the liquidated damages itself are defined as a genuine pre-estimate of the loss which likely to be suffered by the employer in the event of delayed cause by breach of contract.

At this point, there are several numbers of cost components in construction that may get affected by the delay to be considered in calculating the liquidated damages amount. For example, McDonald (1984) stated that loss of profit and financing interest are among the element of costs to be considered in ascertaining the amount of liquidated damages. While on the other hand, Singh (2007) thought that cost on preparation of claims and inflationary cost are the costs to be considered in ascertaining the liquidated damages amount.

1.2 Statement of Problem

The presence of many opinions about what should and should not be included in the calculation of liquidated damages creates confusion among the employers in putting up a genuine pre-estimate value of liquidated damages. Thus, it would be more beneficial to list out and categorise what has been thought to be the cost of losses that the employer may suffer and facilitate the employer to a reasonable liquidated damages amount.

A liquidated damages amount is likely to be challenged if it is too extravagant. It would be wiser to identify the elements of cost which rightly to be included in ascertaining the amount of liquidated damages, so that it will be construed as a genuine pre-estimate sum or amount of the loss incurred by the employer in the event of breach of contract. The building owner will want to claim as much as he can to cover the loss resulted from the delay of completion. However, what can he claim? How is the “loss” computed? What cost items/components can be accounted for as the loss of damages he suffered?

1.3 Objectives of the research

The objectives of the study are:

- (a) To identify the basis in ascertaining the amount of liquidated damages

- (a) To ascertain whether liquidated damages are a reasonable compensation

1.4 Scope and limitation of research

This research combines the local and foreign authors' opinions on cost to be included in ascertaining the liquidated damages amount. There were nine articles ranging from 1980s to the current year of 2012 collected to tabulate the element of cost to be considered in ascertaining the liquidated damages amount. However, the sample of projects analysed were limited to the projects in Malaysia, 3 of them were the government projects while the other 2 were private projects.

1.5 Research methodology

Briefly, the research process was divided into five (5) stages:

- a. Identifying the research area, problems, objectives and scope.
- b. Collecting literature review,
- c. Collecting data and information,
- d. Analysing data,
- e. Writing conclusion and recommendations

1.5.1 Stage 1: Identifying Research Issue

At the initial stage of a research, research issue and problem were identified. This stage involves reading on various sources of published materials, such as journals, articles, seminar papers, other related research papers, newspapers, magazines, and electronic resources as well as going through the World Wide Web and online e-databases from Universiti Teknologi Malaysia, UTM's Online Journal. Aim, objectives, scope and significance of the study were also developed at this stage.

1.5.2 Stage 2: Literature Review

Literature review is the second stage of a research. At this stage, an extensive elaboration on the principle and theories of compensation and liquidated damages in details is done. Secondary data for the research, such as books, journals, newspapers and reported court cases from Malayan Law Journal will be referred to.

1.5.3 Stage 3: Data and Information Collection

Stage 3 of the research is data and information collection. It is crucial to achieve the objective of the research. In order to achieve the first objective, random samples of articles written by local and foreign authors with various backgrounds were analysed. The key element for this research is to identify the cost to be considered in calculating liquidated damages. The costs mentioned were then tabulated out in a table to ease the analysing process.

The outcome from the first objective will lead to the second objective. The elements of cost in ascertaining the amount of liquidated damages will be the basis in achieving the second objective. There were five random projects selected and the cost were then analysed to determine whether the amount of liquidated damages agreed was a reasonable compensation to the employer.

1.5.4 Stage 4: Research Analysis

The analysis of data at this stage will determine whether the objective is achieved. At this stage, documentary analysis was chosen as a method in analysing the data collected.

1.5.5 Stage 5: Conclusion and Recommendations

At the end of the research, a conclusion is made and appropriate recommendation in relation to the issues of the research is lined up to expand the area of research and create a better research later.

1.5.6 Research flow chart

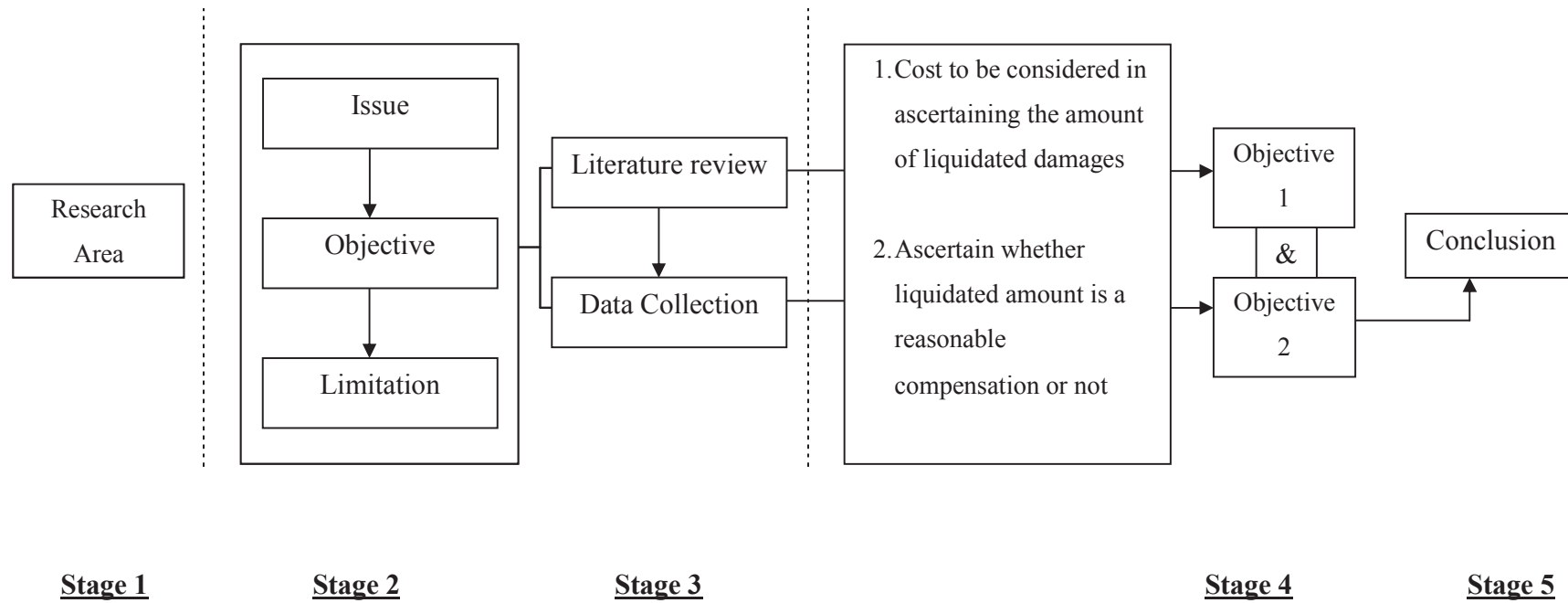


Figure 1.1 Research Flow Chart

1.6 Chapter Organisation

This research is divided into the following chapters.

1.6.1 Chapter 1: Introduction

This chapter focuses on the discussion leading to the development of the research proposal. It is divided into sub-chapters such as background of the research, problem statement, objectives of the study, scope and limitation of the study, the research methodology and chapter organization of the research.

1.6.2 Chapter 2: Literature Review

This chapter discusses the theory and principle of compensation claimable by the employer (innocent party). The position of liquidated damages in common law and Malaysian construction industry is further elaborated. There are also provisions of liquidated damages in the condition of contract and the Contract Act. It includes how the application of liquidated damage becomes illegitimate. The nature and features of liquidated damages clause are also identified. As liquidated damages provide the sum of amount in the letter of award, the calculation of liquidated damages and costs incurred in are also identified.

1.6.3 Chapter 3: Research methodology

This chapter details out what are the methods used to collect and analyse the data in order to achieve the objectives of the research.

1.6.4 Chapter 4: Data analysis

This chapter highlights and discusses the outcome from the data analysis which later answer the research objectives

1.6.5 Chapter 5: Conclusion and recommendation

This chapter concludes the elements of cost to be considered as a basis in ascertaining the amount of liquidated damages in Malaysia. It is also to ascertain whether the current liquidated damages amount set in most of the contract is a reasonable compensation to the aggrieved party. Recommendations for future research are also made in this chapter.

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