

A brief review of commercial issues relevant to the construction, engineering and energy industries.

That approach to the construction of liquidated damages clauses was said to be similar to the Privy Council's approach in Webster and Bosanquet³ and as set out in a passage in Treitel's Law of Contract⁴. The passage in Treitel which "correctly states the law", highlighted that liquidated damages may be construed as penal, and therefore void and unenforceable, if they could become due on a trifling breach even though the breach that actually occurred was a major one for which the liquidated damages were a genuine pre-estimate. Therefore, "the courts will do their best to avoid such results by construing the contract so as to make the sum payable only on major breaches, for which it is a valid pre-estimate."

There are clearly potential problems with such an approach as the distinction between a major and minor breach is not always easy to draw and is likely to give rise to uncertainty and unnecessary argument. For its part, the Court suggested that major breaches were those "giving rise to

substantial loss of the kind contemplated by the liquidated damages clause" but even this definition fails to fully clarify the position.

However it appears from the facts of Cenargo that, in circumstances where a defect potentially gives rise to a contractual liability in liquidated damages but such defect can be remedied at a substantially lower cost than the liquidated damages that would be payable, it will potentially be open to the builder to argue that it should be liable only for the costs of remedying that defect, not for liquidated damages.

Accordingly and to avoid future argument, the parties to a shipbuilding contract should set out as clearly as possible the types of breach to be covered by the liquidated damages provisions.

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1 Clydebank Engineering & Shipbuilding Co. Ltd v Don Jose Ramos Izquierdo y Contaneda [1905] A.C. 6

2 Pneumatic Tyre Company Ltd v New Garage Motor Company Ltd [1915] A.C. 79 as applied by the Privy Council in Philips of Hong Kong v AG of Hong Kong (1993) 61 BLR 41.

3 [1912] AC 934

4 10th Edition (1999) at p.932

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If you have any comments on the issues raised in this edition or there are any subjects you would like to see addressed in future issues of this newsletter please contact Mark Stewart

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LIFE CYCLE COSTING

A decent cost plan is a must for a developer/owner considering a new building. The total costs of the building need to be considered for the cost plan to be effective. These will embrace both initial and future costs. The cost plan can then be used to compare various options of design, materials, components and constructional techniques. The cost plan can also be used by a developer/owner to compare costs against value accruing from future rents.

As the name suggests, life cycle costing takes account of the total costs associated with the whole life of the building. The technique is an economic analysis to assess the real costs of the project. These will include everything from:

- Acquisition costs
- Financing costs

- Operational costs
- Maintenance, repair, refurbishment costs
- Occupancy costs
- Residual values and redevelopment costs

Hence the life cycle costing approach is concerned with the time-stream of costs and benefits that flow throughout the life of a project, with future costs and benefits converted to present values by the use of discounting techniques. This way the economic worth of the project can be assessed at conception.

The idea behind converting costs to present values using discounting

techniques is so that the vast range of factors and variables can be reduced to a comparison of a single cost assessment of the value of the building.

The role of life cycle costing is to provide a means of choice in circumstances where there are several ways of achieving the objective. Changes in design may not affect the acquisition costs i.e. the costs of the land and the construction costs, but may have a major effect on the operational and maintenance costs. For example, there may be a decision to be made as to whether to construct the building walls from brick or some form of proprietary cladding. The difference in cost of materials and construction labour may be marginal, but the operational costs, in terms of heating, lighting, cleaning, maintenance etc. may vary considerably.



Building life, and running costs, will be influenced by obsolescence in terms of:

- Functionality i.e. the point where the building ceases to function for the same purpose as that for which it was built.
- Economic i.e. obsolescence is reached when occupancy of the building is not the least cost alternative.
- Structural i.e. the point at which the building is likely to collapse due to structural failure.

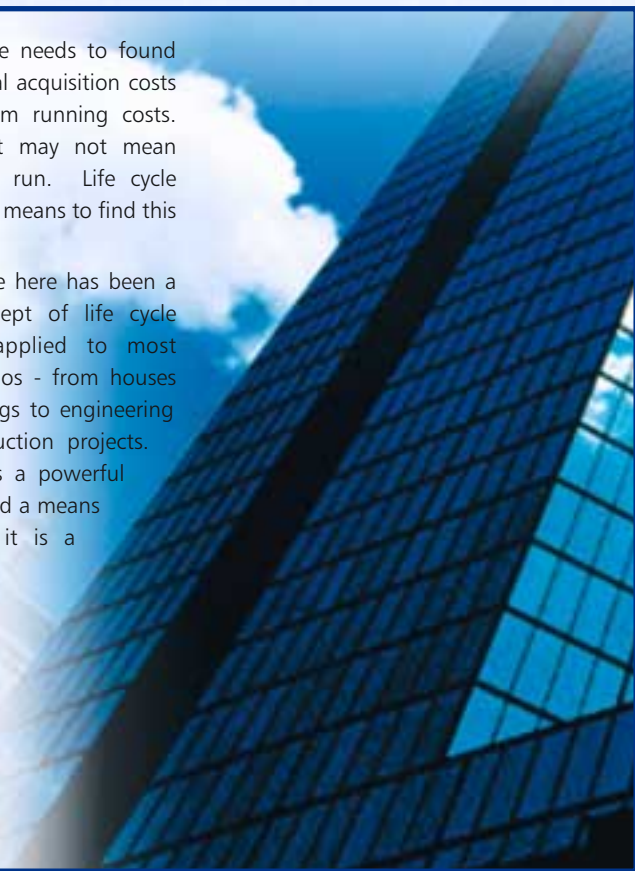
These factors influence both the running costs and the value accruing through rental income.

The relative importance of initial and running costs respectively can be influenced greatly by the financial interests of the developer/owner. One who intends to build and occupy the building will be concerned that the initial and running costs provide best value in the long run. Whereas, one who intends to build and then dispose of the building may be more focused on the initial costs in the short term unless the running costs would have a profound effect on the selling price.

Therefore, a balance needs to be found between those initial acquisition costs and the longer term running costs. Cheap at the start may not mean cheap in the long run. Life cycle costing provides the means to find this elusive balance.

Although the theme here has been a building, the concept of life cycle costing can be applied to most construction scenarios - from houses to industrial buildings to engineering and marine construction projects. Life cycle costing is a powerful tool as an aid to, and a means of, cost planning it is a powerful tool.

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“CENARGO LTD V EMPRESSA NACIONAL BAZAN DE CONSTRUCCIONES NAVALES”

by Rob Jardine-Brown a senior associate with Curtis Davis Garrard

Liquidated damages provisions in shipbuilding contracts are designed to provide both the buyer and the builder with certainty as to the level of compensation due to the buyer for various breaches of contract, e.g. for delays in delivery of the vessel and/or for non-compliance with the vessel's principal performance criteria. As a result, the level of such compensation is generally the subject of lengthy commercial negotiations between the parties. However, although the amount of liquidated damages payable is clearly important, the recent decision in the Court of Appeal in the case of *Cenargo Ltd v Empresa Nacional Bazan de Construcciones Navales* [2002] EWCA Civ 524 (“*Cenargo*”) has highlighted a

number of additional issues which should be considered by the parties when negotiating liquidated damages clauses.

The dispute related to the construction of two Ro-Ro ferries, the MV Dawn Merchant and MV Brave Merchant (together the “Vessels”), at the Seville shipyard of Empresa Nacional Bazan de Construcciones Navales Militares (the “Builder”). The owner of the Vessels, *Cenargo Ltd* (the “Buyer”) brought various claims against the Builder under the shipbuilding contracts (the “Contracts”), for breach

of warranty provisions in respect of the capacity of the Vessels.

Under Article I.4 of the Contracts headed “Description and Class”, it was stated that the Vessels “shall have a Ro-Ro freight capacity of at least 146, 13 metre slots”. Article III.5 provided that if the actual trailer carrying capacity of the Vessels was less than 146 Units of 13 metres each, the Builder would pay to the Buyer as liquidated damages US\$150,000 for each trailer unit by which the Vessel was deficient, excluding the first such unit.

There was an issue between the parties as to the Vessels’ capacity requirements under the Contracts. It was held at first instance and upheld on appeal that, as a matter of construction, the Contracts properly provided for Vessels with a capacity of 146 slots, each slot of 13 metres in length.

The Buyer argued that on that construction, each of the Vessels was deficient by 6 slots (the “Slots”). It was common ground between the parties that the Slots were unable to be utilised as at delivery solely on account of various minor constraints and that the cost of the work necessary to make the Slots available would be approximately US\$11,000. However, Mr Justice Andrew Smith, the judge at first instance, stated that the question to be asked was whether the constraints could properly be characterised as affecting the actual trailer carrying capacity of the Vessels as at delivery. On that analysis, the judge held that in breach of Article I.4, the Vessels were each deficient by four spaces as at delivery and the Builder was therefore liable for liquidated damages amounting to US\$450,000 in respect of each of the Vessels. Neither party was satisfied with that result and both appealed the decision insofar as it went against them.

The Court of Appeal overturned the decision at first instance and, in upholding the Builder’s

appeal, held that there had been no breach of Article I.4 and therefore no claim for liquidated damages under Article III.5. It reasoned that the true question to be asked was whether the Vessels were capable, on delivery, of carrying 146 trailers in 13 metre Slots and held that the Vessels were capable of so doing, even though minor adjustments were required to actually enable 146 trailers to be carried. Instead the constraints should be characterised as defects in design/workmanship which would have entitled the Buyer to make a guarantee claim under Article X of the Contracts had such a claim been brought within the guarantee period. Perhaps of more significance, the Court of Appeal held that even if there had been a breach of Article I.4 the loss resulting from the breach was not intended to be covered by the liquidated damages provisions set out in Article III.5.

In construing liquidated damages clauses, the established position under English law is that, (i) the agreed level of liquidated damages must

represent a genuine pre-estimate of loss arising from the breach(es) to which they relate, (ii) where the agreed compensation is “extravagant and unconscionable”¹ the relevant clause will be categorised as a penalty and unenforceable and (iii) whether the agreed compensation is properly categorised as a penalty or a valid liquidated damages clause will be determined in relation to the particular circumstances of each case judged as at the time that the contract was made².

In *Cenargo*, the Court of Appeal stated that liquidated damages clauses should additionally be construed so as to avoid, if possible, the result that breaches of contract resulting in minor losses would be covered by such clauses. To construe a liquidated damages clause otherwise would be to jeopardise that clause as, “if a liquidated damages clause is held to apply to trifling breaches of contract or breaches of contract which result in a trifling loss, the whole clause might be struck down as a penalty clause”.

