Before Lord McCluskey; Clerk LJ**;** Lord Kirkwood : Inner House Court of Session : 20th May 2003.

OPINION OF LORD JUSTICE CLERK :

Introduction:

[1] This is a reclaiming motion by the defenders from an interlocutor of Lord Macfadyen dated 24 July 2001 pronounced in the commercial court by which, *inter* alia, he allowed parties a proof before answer on the summons and defences, as then adjusted, under deletion of certain averments in the defences.

[2] The pursuers and the defenders are employer and contractor respectively under a contract dated 15 October and 11 November 1998 for the construction of a hotel at Temple Way, Bristol. The contract incorporates the conditions of the Standard Form of Building Contract (Private Edition With Quantities) (1980 edition) with supplemental provisions that include a schedule of special amendments. A Minute of Variation dated 13 May and 24 August 1999 provides for adjudication of disputes and for a right of appeal to the court.

The dispute

[3] The contractual completion date is 25 January 1999. It is agreed that the contract works were not completed by that date. The pursuers insist that that remains the completion date. The defenders contend that, by reason of certain instructions issued to them by the architect, they became entitled to an extension of time. The matter was referred to the architect. He allowed an extension of four weeks. An adjudicator then allowed a further extension of five weeks.

[4] In this action the pursuers contend that both allowances were unjustified. They conclude for (1) declarator that the completion date is 25 January 1999; (2) declarator that in terms of the contract the defenders were not entitled to the four weeks extension granted to them by the architect; (3) payment by the defenders of £120,000, with interest; (4) payment by the defenders of £150,000, with interest; (5) payment by the defenders of £63,000, with interest; and (6) expenses. The basis of conclusions 3, 4 and 5 is that the defenders failed to complete the works by the completion date and were in breach of contract as from that date. The claim for £120,000 is a claim for liquidated and ascertained damages in respect of the four weeks extension allowed by the architect. The claim for £150,000 is a claim for repetition of a payment made by the pursuers to the defenders, which would not have been made if the adjudicator had not allowed the additional extension of five weeks. The claim for £63,000 is a claim for repetition of a sum certified by the architect as being direct loss and expense incurred by the defenders in consequence of the extension that he allowed.

[5] The defences to the action were to the effect *inter* alia that the defenders were entitled to the extensions of time awarded by the architect and the adjudicator. The pursuers' response at adjustment was that that defence was irrelevant because the defenders had failed to comply with the requirements of one of the special conditions, namely clause 13.8, that applied to the extensions in question. The defenders reply to that was that the pursuers' reliance on clause 13 was irrelevant.

[6] We are dealing at this stage only with certain preliminary questions of relevancy. We agree with counsel that these are questions that can be decided at this stage on a construction of the contract.

The contract

[7] To put the critical issues in context, it is necessary first to consider the terms of the contract that have a bearing on the question of the completion date. Clause 4 of the contract confers a general power on the architect to issue instructions in the course of the work. Clause 23.1.1 provides inter alia as follows:

" ... the Contractor ... shall ... regularly and diligently proceed with the [works] and shall complete the same on or before the Completion Date."

Clause 24.2.1 provides inter alia as follows:

" ... the Contractor shall ... pay or allow to the Employer liquidated and ascertained damages at the rate stated in the Appendix ... for the period between the Completion Date and the Date of Practical Completion."

The rate stated in the Appendix is £30,000 weekly pro rata. It is agreed that that is a genuine pre-estimate of the employer's probable loss if the contractor should delay in completion.

Clause 25.3.3 provides inter alia as follows:

"After the Completion Date, if this occurs before the date of Practical Completion, the Architect may, and not later than the expiry of 12 weeks after the date of Practical Completion shall, in writing to the Contractor either

1. *fix a Completion Date later than that previously fixed if in his opinion the fixing of such later Completion Date is fair and reasonable having regard to any of the Relevant Events, whether upon reviewing a previous decision or otherwise and whether or not the Relevant Event has been specifically notified by the Contractor under clause 25.2.1.1; or*
2. *Fix a Completion Date earlier than that previously fixed under clause 25 if [certain conditions are fulfilled]."*

The relevant events are defined in clause 25.4 and are, in general, events over which the contractor has no control.

[8] Clause 1.3 defines the expression *"Date for Completion"* as meaning *"the date fixed and stated in the Appendix"*. Clause 1.3 defines the expression *"Completion Date"* as meaning *"the Date for Completion as fixed and stated in the Appendix or any date fixed under either clause 25 or 33.1.3"*. Clause 33.1.3 can be disregarded for the purposes of this case.

[9] From these provisions it is clear that the completion date, which is the date on which any liability for delay emerges, is the contractual date for completion or any date to which the construction period is extended by virtue of a valid extension of time given in terms of the contract.

[10] It is not disputed that in addition to his general power to issue instructions under clause 4 (supra), the architect in this case had the specific power to issue an instruction for a variation of the works under clause 13.2, which we need not quote.

[11] This is the background to clause 13.8 with which this case is concerned. Clause 13.8 is one of the special amendments to which we have referred. It is in the following terms:

"13.8.1. Where, in the opinion of the Contractor, any instruction, or other item which, in the opinion of the Contractor, constitutes an instruction issued by the Architect, will require an adjustment to the Contract Sum and/or delay the Completion Date, the Contractor shall not execute such instruction (subject to Clause 13.8.4) unless he shall have first submitted to the Architect, in writing, within 10 working days (or within such other period as may be agreed between the Contractor and the Architect of receipt of the instruction, details of:

1. *initial estimate of the adjustment (together with all necessary supporting calculations by reference to the Contract Documents);*
2. *initial estimate of the additional resources (if any) required and his method statement for compliance;*
3. *initial estimate of the length of any extension of time to which he considers he is entitled under Clause 25 and the new Completion Date (together with all necessary supporting documentation by reference to the Master Programme);*
4. *initial estimate of the amount of any direct loss and/or expense to which he may be entitled under Clause 26; and*
   1. *any such other information as the Architect may reasonably require.*
   2. *The Contractor and the Architect shall then, within 5 working days of receipt by the Architect of the Contractor's estimates, agree the Contractor's assessments. Following such agreement, the Contractor shall immediately thereafter comply with the instruction and the Architect shall grant an extension of time under Clause 25.3 of the agreed length (if any) and the agreed adjustments (if any) in relation to Clauses 13.8.1.1 and 13.8.1.4 shall be made to the Contract Sum.*

13.8.3. If agreement cannot be reached within 5 working days of receipt by the Architect of the Contractor's estimate on all or any of the matters set out therein; then;

1. *the Architect may nevertheless instruct the Contractor to comply with the instruction; in which case the provisions of Clauses 13.5.25 and 26 shall apply; or*
2. *the Architect may instruct the Contractor not to comply with the instruction, in which case the contractor shall be reimbursed all reasonable costs associated with the abortive instructive (sic).*
4. *The Architect may, by notice to the Contractor before or after the issue of any instruction, dispense with the Contractor's obligation under Clause 13.8.1, in which case the Contractor shall immediately comply with the instruction and the provisions of Clauses 13.5.25 and 26 shall apply.*

13.8.5. If the Contractor fails to comply with any one or more of the provisions of Clause 13.8.1, where the Architect has not dispensed with such compliance under Clause 13.8.4, the Contractor shall not be entitled to any extension of time under Clause 25.3."

Clause 13.8.5 therefore has the effect that if the contractor on receipt of an instruction fails to take action under clause 13.8.1, he not only loses his entitlement to an extension of time under clause 25.3 (supra) but incurs a potential liability to pay liquidate damages under clause 24.2.1 (supra) if, by reason of the instruction, he should fail to meet the completion date.

The pleadings

[12] The parties agree that the contract work was not completed by the contractual completion date of 25 January 1999. They also agree that the architect did not waive compliance by the contractor with the provisions of clause 13. The pursuers contend that the defenders failed to take action under clause 13.8.1 and in consequence are not entitled to any extension of time in respect of the instructions. The defenders claim that they are entitled to both of the extensions granted to them; but that, in any event, clause 13.8 does not disqualify those claims (a) because clause 13.8.5 is a penalty clause and is therefore unenforceable (the penalty clause point); and (b) because, in any event, that clause applies only if the contractor, on receipt of an instruction, actually forms the relevant opinion to which the clause refers (the trigger point).

[13] The defenders' averments on the penalty clause point are as follows:
"Ans. 8(i) clause 13.8.5 amounts to a penalty clause and as such is unenforceable. In the event of a breach by the defenders of clause 13.8.1, the effect of 13.8.5 would be to deprive the defenders of extensions of time to which they would otherwise have been entitled and to expose the defenders to liability for liquidate and ascertained damages to which they would not otherwise have been exposed. The rate of liquidate and ascertained damages was a pre-estimate of the loss and damage which the pursuers might sustain as a result of delay in completion and not of the loss and damage which they might sustain as a result of the breach of clause 13.8.1."

To this, the pursuers reply as follows:
"Clause 13.8 is not a penalty clause. It imposes a mandatory condition precedent to the defenders' entitlement to an extension of time. The satisfaction of that condition precedent was within the control of the defenders."

The defenders' averments on the trigger point are *inter alia* as follows:
"Ans 8(ii) clause 13.8.1. only applied if the defenders, upon receipt of the instruction, actually formed the opinion about the requirements of the instruction as set out therein."

To this, the pursuers reply *inter alia* as follows:
"The application of Clause 13.8 is conditional upon the defenders forming an opinion on certain matters. It is implicit in the terms of clause 13.8 that on receipt of an instruction the defenders required to address their minds (with a view to compliance with clause 13.8) to the question of whether or not the instruction would require an adjustment to the Contract Sum or delay the Completion Date. In all the circumstances of the present case it is believed and averred that the defenders did not address their minds to these matters with a view to compliance with clause 13.8. The defenders are not entitled to found on their own failure as a basis for denying the application of clause 13.8. The opinions formed by the defenders from time to time are uniquely within their knowledge ... "

The decision reclaimed against and the grounds of appeal

[14] The Lord Ordinary found for the pursuers on the construction of clause *13.* He therefore excluded from probation the defenders' averments in answer *8(i)* and *8(ii)* on the two points to which we have referred. The Lord Ordinary also excluded from probation certain parts of answer *8(iii),* which we need not quote. *Quoad ultra* he allowed proof before answer.

[15] The defenders reclaimed against the interlocutor on four grounds; but at the hearing they insisted in only two, namely those relating to the penalty clause issue and to the trigger issue. Counsel for the defenders moved us under both grounds of appeal to allow proof before answer on the summons and defences, as adjusted, and in effect to restore the averments that the Lord Ordinary excluded from probation, but under deletion in either case of certain of the pursuer's averments. The submissions for

the parties at the hearing of the reclaiming motion were in substance those advanced before the Lord Ordinary.

The Lord Ordinary's Opinion

The penalty clause point

[16] It is agreed between the parties that the court will regard a contractual provision as imposing a penalty, and therefore as being unenforceable, if it stipulates for payment by one party to the other of a sum of money which (a) is payable on the occurrence of a breach of contract committed by the former and (b) is not a genuine pre-estimate of the loss likely to be suffered by the latter as a result of the breach, but is instead designed to operate *in terrorem,* or oppressively or punitively (cf. ***Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd,*** *[19151 AC 79,* Lord Dunedin at *p. 86).*

[17] The Lord Ordinary first considered whether a failure by the contractor to comply with one or more of the provisions of clause *13.8.1* constituted a breach of contract or merely provided a procedure that the contractor was obliged to follow if he was to preserve his entitlement to an extension of time on receipt of an architect's instruction. The Lord Ordinary rejected the latter interpretation. He considered that the clause had a wider effect, namely that if the contractor, having formed the opinion set out in clause 13.8.1, elected not to do what the clause required of him, he not only deprived himself of any entitlement that he would otherwise have to an extension of time, but also deprived the architect of the opportunity stipulated for by the employer to review the instruction in the light of the contractor's representations as to its consequences and to decide whether to insist in the instruction or to withdraw it (Opinion, paras. [161- [181). In such a review, the architect would take into account not only the effect of the instruction in producing delay but its effect on the contract sum and on the direct loss or expense incurred by the contractor. For that reason, the Lord Ordinary considered that clause 13.8.3 was of material value to the employer. It would therefore not be right to construe the apparently obligatory words of clause 13.8.1 as merely conferring an option, rather than imposing an obligation, on the contractor. He concluded that failure by the contractor to comply with one or more of the provisions of clause 13.8.1 was properly to be regarded as a breach of contract on his part. The first requirement of the rule against penalty clauses was therefore satisfied.

[18] The Lord Ordinary then considered whether clause 13.8.5, in depriving the contractor of the opportunity to obtain an extension of time, thereby imposed on him a liability to pay or to allow liquidate damages, and should therefore be considered to turn the liquidate damages provision into a penalty for breach of clause 13.8.1. He accepted that the contractor could avoid liability for the weekly sum of £30,000 for delay caused by the instruction if, by compliance with clause 13.8.1, he obtained an extension of time. He accepted too that that liability did not bear to be a genuine pre-estimate of any loss suffered by the employer in consequence of the contractor's failure to comply with clause 13.8.1. He therefore accepted that there was, in a sense, a causal connection between the contractor's failure to comply with clause 13.8.1 and his liability to pay a sum unrelated to the loss actually resulting to the employer from the breach of contract (as he held it to be). But he considered that that view overlooked the fact that the delay caused by the instruction was delay of a sort that the parties had agreed was likely to cause the employer loss at the pre-estimated rate. If the contractor failed to take steps under clause 13.8.1 to secure an extension of time, his failure preserved for the employer his entitlement to the pre-estimated weekly sum that he might have lost by reason of such an extension. The sum of £30,000 remained payable by the contractor as a result of delay in completion and not as a penalty for failure to take the steps referred to (Opinion, para. [191).

The trigger point

[19] The Lord Ordinary rejected the contention for the defenders that the pursuers' case under clause 13.8.1 was irrelevant because the pursuers had failed to aver that the defenders actually formed the opinion contemplated by that provision which triggered the claim for an extension of time. Having considered the consequences for the contractor of a failure to provide the architect with the information referred to in clause *13.8.1,* he concluded that the clause impliedly obliged the contractor, on receipt of the instruction, to apply his mind to it and to form a view as to its likely consequences in the respects specified. If that were not the case, the operation of the further procedure specified under clauses

13.8.2 and *13.8.3* would depend on whether the contractor bothered or chose to think about those consequences. The Lord Ordinary considered it unreasonable to suppose that what was intended was such an uncertain operation of the clause (Opinion, para. *[231).*

Decision

[20] In our opinion, the Lord Ordinary reached the right result in this case, although we differ from him in one important aspect of his reasoning.

The penalty clause point (answer 8(i))

[21] In the context of clause *13.8*, in our opinion, neither of the conditions necessary for the creation of a penalty clause is satisfied in this case.

a. Whether failure by the contractor to take action under clause 13.8.1 constitutes a breach of contract

[22] This issue arises because, in order to have clause *13.8.5* construed as a penalty clause, the defenders have to argue that where they do not operate the procedures laid down in clause *13.8.1*, they themselves commit a breach of contract. In holding that in that case the contractor commits a breach of contract, the Lord Ordinary considered that the breach consisted in the contractor's failure to form an opinion on the question raised by the instruction and defined in the clause and to intimate the relevant estimates based on that opinion. In the argument before us, however, counsel for the defenders argued that the breach consisted in the contractor's proceeding to carry out the work.

[23] In our opinion, the contractor would not commit a breach of contract in either respect. Clause *13.8* does not impose any obligation on the contractor when he receives an architect's instruction. If the contractor receives such an instruction, he has to consider its likely effects, and in particular its likely effect on the duration of the building period. He may, for reasons of his own, decide to accept the instruction without resistance and hope that he will be able to complete the work, as varied by the instruction, within the building period. But if he wishes an extension of time, he must comply with the conditions precedent that clause *13.8* provides for in these specific circumstances (cf. cl. *13.8.5).* In particular, he must serve notice on the architect of his estimate of *inter alia* the probable cost. In the light of that the employer may take the opportunity to withdraw the instruction. But if the contractor fails to take the steps specified in clause *13.8.1*, then unless the architect waives the requirements of the clause under clause *13.8.4*, the contractor will not be entitled to an extension of time on account of that particular instruction.

[24] In short, clause 13.8 provides the contractor with an additional right, in the specific case to which it applies, that would not be available to him in the case of an instruction issued under the general provisions of clause 4. But clause 13.8 does not oblige the contractor to invoke its protection. It merely provides the contractor with an option to take certain action if he seeks the protection of an extension of time in the circumstances in which the clause applies. The provisions of clause 13.8, in our view, are merely conditions precedent to his doing so.

[25] If the contractor fails to take action in accordance with clause 13.8.1, it is a false analysis to describe him as being in breach of contract. The ultimate effect of that failure may be that he is unable to complete the works, as varied by the instruction, by the completion date; although that cannot be assumed at that stage. But the breach of contract that that would constitute would not be a breach of clause 13.8. It would be a breach of clause 23 (supra), of which the ultimate cause may be the contractor's failure to take advantage of clause 13.8.

[26] For these reasons, we consider that the clause does not oblige the contractor to respond to the instruction in accordance with the clause and thereby to give the architect the opportunity to reconsider the instruction. If the architect issues an instruction that may have such consequences, the chance that the contractor will not contest it is just one of the risks that the architect takes. If therefore the contractor goes ahead with the work in accordance with the instruction, he does not commit any breach of contract. In this respect we disagree with the Lord Ordinary's reasoning.

(b) Whether clause 13.8.5 imposes a penalty

[27] On the view that we have taken on the preceding question, this question does not arise. We should say, however, that if we were to treat the defenders' failure to operate clause 13.8 as a breach of contract, we cannot see how that would result in the payment of a penalty in the legal sense of that expression (eg **Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd**, supra, Lord Dunedin at p. 87). The sum complained of is not payable at that stage, and may never be payable. What is, on this assumption, a breach of contract merely gives rise to the possibility, the likelihood of which will depend on the circumstances of the case, that liquidate damages will become due at a later date. If that liability should in due course arise, it will not arise as a consequence of the assumed breach of contract under clause 13.8, but as a consequence of the contractor's breach of clause 23 consisting in his failure, for whatever reason, to complete the contract works on or before the completion date. We agree with the reasoning of the Lord Ordinary on this point.

The trigger point (answer 8(ii))

[28] Although this point is pled as applying "in any event," we consider that if the appeal fails on the first ground, it must fail on this ground too. If there has been no breach of contract on the part of the defenders, this reclaiming motion fails.

[29] We should say, however, that where the forming of a certain opinion as to the consequences of an instruction is a condition precedent to the contractor's invoking clause 13.8, the contractor cannot be heard to say that by reason of his failure to form such an opinion the clause was not brought into effect. In our view, it is implicit in a contractual arrangement of that kind that the contractor must apply his mind to the instruction and form a view as to its likely consequences. On this aspect of the case too, we agree with the view of the Lord Ordinary.

Interlocutor

[30] In the circumstances, we shall refuse the reclaiming motion.

Act: Keen, QC; McGrigor Donald
Alt: Currie, QC, Borland; Masons