# Brave New World – Selected Jurisdictional Pitfalls when Acting on International Waste-to-Energy Projects

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Over the last few years, Waste-to-Energy (*WtE*) projects became increasingly international. In times of low interest rates, solid infrastructure projects with their fix return rates are more and more attractive to project developers, international investors as well as EPC and O&M contractors. They attract financial and strategic investors which would otherwise not turn towards these rather long-term investments. Therefore, a continuously increasing number of international players from different jurisdictions is entering the global playing field.

Usually such international WtE projects are tendered through Public Private Partnership (*PPP*) schemes. PPPs have been very popular around the world and were particularly used in the power, waste, wastewater healthcare and transportation sector. While the public partner usually delivers the input for the plant – e.g. municipal waste – or pays an availability fee, the private partner is responsible for the construction, financing and operation of the plant (so-called Build-Operate-Transfer agreement – *BOT*). At the end of the partnership, the asset will usually be transferred to the public partner.

Such PPP schemes in the WtE sector are accompanied by a significant amount of ancillary agreements to be executed by the sponsors of the project through their investment vehicle, such as Engineering, Procurement and Construction (EPC)(sub-) contracts, Power Purchase Agreements (PPA), Operation and Maintenance (O&M) Agreements, Waste Supply Agreements, Grid Connection/Usage Agreements etc. All of these agreements will have to take into account the requirements of the specific project, the applicable law as well as the interests of the stakeholders involved – there is no *one size fits them all* and it is therefore crucial to identify reasonable and tailor-made (bankable as well as affordable) solutions for the benefit of the parties and the overall project success.

The purpose of this article is to discuss some of the most common jurisdictional pitfalls in international WtE projects and explain them by illustrating short case studies at the end of each chapter. The most critical phase of a WtE project is usually the construction phase up until the delivery of the facility to the owner and the commencement of the commercial operation period. The main focus of this article lies, therefore, on issues around the early phases of the development of a WtE project.

## 1. Sovereign risks

Infrastructure investments such as investments in WtE projects require a detailed risk analysis, risk allocation and risk mitigation. One of the many risks that an investor faces when investing in a foreign country is the sovereign risk or, in other words, country risk. This risk is associated with the host country characteristics. Sovereign risk comprises both political and financial risks that can arise due to host country's vulnerable political and financial situation.

Political risks are the result of the host country's political instability or its fairly trifling institutional quality. Some examples of political risks are host country's internal or external conflicts; its potential corrupted system; its governmental instability; its democratic accountability; its ethnic and religious tensions. Financial risks refer to the host country's capacity to repay its foreign liabilities. The assessment of these risks can be based on the host country's external debt as a percentage of its GDP, its external debt service as a percentage of exports of goods and services, its revenues and expenditures expressed as a percentage of its GDP, its inflation rate etc. Sometimes, foreign investors seek to avoid such financial risks by funding their project with state independent loans such as loans from the World Bank or the European Investment Bank reducing in that way their exposure to exchange rates fluctuations.

Practically, political risks can be project specific or of rather general nature. In particular, the government of the host country may take actions against a specific investment by adopting discriminatory regulations or by breaching its contract with the investor or even by expropriation. On the other hand, some sovereign risks, such as internal conflicts, regulatory changes, currency inconvertibility can be faced by all investors and in many jurisdictions.

Foreign investors investing in developing economies are seeking to effectively manage sovereign risks in order to avoid exposing their investment to severe losses. Hence, they are trying to contractually and legally protect their investments.

Often, foreign investors retain a contract with the host government directly or indirectly through its local authorities. Investors, usually, accompany such a contract with an implementation agreement, or in other words, stability or support agreement. An implementation agreement addresses a variety of issues such as sovereign guarantees – guarantees that are given by the host government to assure project funders that the government will take or avoid taking certain actions that may affect the project – currency risks, expropriation, legislative protection, and how the overall cooperation between the host governments, its local authorities and the project investors should be conducted.

Investors are also protected against sovereign risks either by Bilateral Investment Treaties (*BITs*) or by political risk insurances. When investing abroad, each investor should investigate whether or not his investment will benefit from a BIT. BITs are agreements between two countries that set up the terms and conditions for foreign investments in each other's countries. In the event that two countries enter into such a BIT they guarantee vice versa that foreign investors of these countries will be treated equally to investors of the host country. BITs offer protection to investors against various host-government actions and interference. The protection granted under a specific BIT will be determined by its provisions. Generally, BITs foresee a fair and equitable treatment for foreign investors. This means that foreign investments should be treated as favorable as the local investments. They also establish clear boundaries on the expropriation of investments while granting foreign investors with the right to seek compensation in such a case. Expropriation will be justifiable, however, if it takes place in accordance with the international law standards, i.e. for public purposes while a timely, adequate and effective compensation is provided. In addition, expropriation should not be applied at a discriminatory basis and should be carried out under due process of law. BITs also grant the investors with the right of free transfer of funds related to investments out of the host country. Lastly, BITs allow investors to refer disputes to international arbitration against the host government. In practice, governments usually comply with the awards issued by an arbitral tribunal. Awards issued by arbitral tribunals can be enforced on any of the countries[1] which signed the New York Convention on the recognition and enforcement of foreign arbitral awards.

As mentioned in the previous paragraph, investors can also be covered by political risk insurance (*PRI*). That insurance is mainly provided by multilateral agencies, private insurance or export credit agencies and usually covers risks such as currency transfer and convertibility risks, risk of expropriation, breach of the contract between the host country and the foreign investor etc. A PRI has a broader scope of protection comparing to the one under BITs. Essentially, it can provide additional protection for war or political violence, risks that are not usually covered by BITs. In general, PRI is less costly and less time-consuming compared with the protection arising from BITs[2]. In particular, investors who are covered by PRI address their claims against the insurer instead of the host-government – which happens in cases where investors are protected only by BITs. Thus, investors have a fairly straightforward recourse right against the insurer. Usually, claims are being paid after a period of 180 days[2]. There is no need for the investor to initiate an arbitration or litigation showing that the host government breached its obligations. In addition, in case the risk materializes, the PRI holder will receive compensation, if he proves that the insured risk took place and all the terms and conditions of the insurance coverage are being satisfied. Conversely, winning an arbitral award against a host-country cannot guarantee that the compensation will be paid in the end. For instance, in Argentina, foreign investors were granted an award but the compensation awarded to them has been withheld.

1 http://www.uncitral.org/uncitral/en/uncitral_texts/arbitration/NYConvention_status.html

2 http://www.clydeco.com/insight/article/protection-against-sovereign-risk-political-risk-insurance-vs-bilateral-inv

**Case Study**

In Kuwait, a local entity, which is responsible for tendering PPPs invites local and international companies for the PPP of a WtE project. A German bidder company finally wins the tender. Two years after completion and due to diplomatic tensions between Germany and the host state, the local entity mentioned above breaches its contractual obligations arising from its contract with the German company.

The German company filed a claim at the ICSID under the Germany-Kuwait BIT. After a lengthy and costly arbitral tribunal the German company and the Kuwaity local entity agreed to settle after lengthy negotiations about the level of the compensation that should be given to the German company.

## 2. Latent defects

During the defects liability period (*DLP*), the EPC Contractor will rectify any EPC defects identified by the O&M Contractor, the EPC Contractor itself or any third party engineer. EPC defects are considered as the non-compliance with general or specific contractual requirements set out in the technical specifications of the contract. A significant number of such EPC defects may be rather obvious and therefore detected and rectified during the DLP. Following the expiration of the DLP, other EPC defects may become apparent. Such defects are generally referred to as latent defects.

A latent defect is a defect in the property, construction or the works, whether it is a defect of design, workmanship or materials, which existed already at the time of completion, purchase or transfer but was not discoverable by any reasonable inspection.[3] Particularly, in common law jurisdictions it is typical that the employer is still entitled to the rectification of such latent defects after the expiry of the regular DLP. However, the statutory law does not in all common law influenced jurisdictions state the period for which an EPC Contractor shall be liable for latent defects[4]. Therefore, the employer usually seeks to implement a latent defects liability period (*LDLP*) and the EPC Contractor usually seeks to contractually restrict the period of such LDLP.

With regard to the burden of proof of the existence of latent defects upon completion, the English courts – the UK being the pre-dominant jurisdiction for latent defects – regularly rely on presumptions when deciding whether or not a latent defect existed already at the time of the transfer. However, the EPC Contractor bears the burden of proof to establish that the defect was unknown at the time of the transfer.

An issue which often arises in the context of WtE projects is whether the EPC Contractor shall have a right to remedy the latent defects itself or not. During the regular DLP, the EPC Contractor is commonly entitled to rectify the defect. After the end of the DLP this right ends, as statutory law does not provide such right during the LDLP,

[3] Baxall Securities Ltd v Sheard Walshaw Partnership [2002] EWCA Civ 9; cf. Tester, Int. I.L.R. 1993, 284, 284.

[4] For the UK cf. the Latent Damage Act and the Construction Act – additionally, the EPC Contractor will be liable for latent defects under an EPC Contract for the period of time that it is liable for breach of contract (i.e., either six years or 12 years, depending on whether the contract was executed as a deed).

unless one is specifically conferred upon the EPC Contractor by the defects liability provisions or otherwise in the EPC Contract. The outcome purely depends on the parties' negotiation position and varies on a case-by-case basis.[5] Where the employer is entitled to appoint a third party for the rectification of the latent defect in question combined with a damages claim for any (reasonable) costs incurred, he may have a hard time recovering such costs.[6] For example, the EPC Contractor may have faced insolvency in the meantime or may have missed to renew its professional indemnity policy.[7]

**Case Study**

A project company responsible for the construction and operation of a WtE project under a PPP scheme is suing the EPC Contractor over major defects in the flue gas treatment works. According to the project company as the employer, the EPC Contractor failed to exercise the appropriate standards of skill and care in undertaking the design and installation works which led to material cracks in the concrete elements of the flu gas treatment system.

The cracks were discovered five years and three months following the commercial operation date of the WtE facility. The parties have contractually agreed on a DLP of two years and on a LDLP of six years following the commercial operation date. The latent defects may be rectified by the EPC Contractor itself – or by its sub-contractors.

For the rectification of the cracks, the next scheduled inspection of the plant will have to be extended by four weeks. The project company claims damages for loss of profit for this period as well as for any other costs resulting from the defect rectification.

The EPC Contractor rejects the project company's claims and states that the cracks resulted from poor operation of the facility. Additionally, it argues that the potential defect – i.e. the cracks – was reasonably discoverable by the project company during the DLP.

## 3. Responsabilité décennale – decennial liability

One of the key issues that should be considered by EPC contractors who are responsible for the design and the construction of the project as well as by engineers, architects and other design professionals who enter into construction contracts (in particular in the Middle East) is the so-called *responsabilité décennale* or decennial liability. The concept of decennial liability originates in the French Civil Code but there is a quite long list of jurisdictions with a decennial liability or similar regimes in place. For instance, decennial liability can be traced in the Civil Codes of many MENA countries. Even if each regime has its own nuances, the definition given to that concept by the different jurisdictions where it is applicable remains the same. The idea of decennial liability

5 Huse, Understanding and Negotiating Turnkey and EPC Contracts, 2002, p. 338 et seq.

6 Cf. D & F Estates v Church Commissioners [1989] AC 177; Murphy v Brentwood District Council [1990] 3 WLR 414; and Department of Environment v Thomas Bates [1990] 3 WLR.

7 Tester, Int. I.L.R. 1993, 284, 285.

evolved from the need to protect the building owners who, due to lack of technical expertise, could not easily discover a construction or design defect during the delivery of the project or later – in case of a latent defect. For instance, it would not be reasonable expected from the owner of a WtE project to detect any defect, if that defect was caused by equipment which was used for the WtE construction and was expected to be functional during the whole project life cycle but some years after the commencement of the project operation that equipment was proven to be defective.

Decennial liability means a strict liability that is imposed upon contractors responsible for the design and the construction of the project. For the purpose of this chapter, the word contractor will only mean the person who is responsible for the design and the construction of a project. As its name suggests, decennial liability lasts usually for ten years from the date on which the work was handed over to its owner. Contractors are liable for a period of ten years towards the building owner or the purchaser of the power plant for any total or partial collapse of the building or any structural defect which threatens the stability or safety of the building. Such a defect can be detected in the design or construction of the building itself as well as in the soil upon which the building is located.

Decennial liability is a strict liability because the contractor will be held liable in the absence of any evidence of breach of contract or negligence. It is not possible for a contractor to limit his liability. However, he can be absolved from liability by proving the occurrence or existence of Force Majeure or by showing that the damage was caused by an external cause, for instance due to the employer's actions. To illustrate in a better way the concept of the strict liability, two examples of the UAE Civil Code and the French Civil Code will be given. Essentially, article 882 of the UAE Civil Code mentions that *any agreement tending to exclude or limit the decennial liability of the engineer and the contractor shall be void*. Likewise, articles 1792-1795 of the French Civil Code mention that the parties cannot contract around the decennial liability. Any attempt to limit or exclude decennial liability obligations should be deemed invalid and unenforceable. Article 1792 specifically mentions that a contractor may only escape liability by showing that the damage was caused by an external event such as a force majeure or a major natural disaster.

Apart from the owners, decennial liability also offers more security to investors as contractors will be liable for a ten-year period following a project's completion. In many jurisdictions in Continental Europe, for instance, where decennial liability is not applicable, the end of the defect liability period can be shortened than the one provided under the decennial liability regime.

Decennial liability significantly differs from professional liability. As illustrated in the previous paragraph, decennial liability is considered as a strict liability, and thus, no negligence, error or omission should be proven. Conversely, under the professional liability, a contractor can be held liable only for its own negligence, error or omission.

Moreover, decennial liability holds a contractor jointly liable with the other contractors. Essentially, a contractor can be held liable for a defect even if it can be shown that this defect was caused solely by another contractor. That means that all contractors are each liable up to the full amount of the damage caused. On the other hand, professional liability holds a contractor liable only in proportion with the damage he caused or with a structural flaw he was responsible for.

Based on the above, decennial liability is a lurking risk and one of the greatest risks a contractor cannot escape. Limitation of liability clauses on behalf of contractors are invalid in jurisdictions where the decennial liability applies. For their protection, contractors should check the sufficiency of the site information and, if necessary, carry out their own site investigation. Additionally, since the parties cannot agree to limit or exclude decennial liability, they should cover any risk that triggers the decennial liability by obtaining specific insurance coverage. In many countries, such as in Iraq, Jordan, Kuwait and the UAE, obtaining insurance in respect of the decennial liability is not a mandatory requirement. Conversely, in some other countries such as in Algeria, Cameroon, Denmark, Egypt, France etc the decennial liability insurance is mandatory and very costly. In the Middle East, the availability of such insurance is limited and fairly unattractive to the majority of contractors due to its high cost. Nevertheless, even if an insurance which covers the decennial liability is not compulsory, it is strongly advisable for contractors to carry an insurance that covers such liability. Lastly, what contractors should always bear in mind when planning to enter into a contract for a project in a country where the decennial liability applies is that they have to protect themselves against the decennial liability even if the law that governs their contract with the owners is not in line with the concept of decennial liability. For instance, a project is developed in Kuwait, where the decennial liability is applicable; however, the contract between the contractor and the owner of a project is governed by the law of another country, ie. Germany. German law does not foresee the decennial liability. In such a case, the decennial liability will still be applicable since the project is located in Kuwait where the decennial liability is a mandatory concept and, thus, any limitation of liability clause will be against the ordre public.

**Case Study**

The project parties develop a WtE project in a GCC state. The parties chose a local law to be applicable. The turn-key construction process went smoothly, the construction was finished and the WtE plant was handed over to the project developer. At the time of acceptance, no major defects were apparent. The WtE plant started the operational phase.

Ten months after the construction was finished, cracks in the power plant boiler appear due to adefective steel that could not endure the high temperatures. The project developer claims full compensation based on decennial liability. The constructor is not willing to pay. After two years of expensive arbitration, full compensation is awarded to the project developer. The decision is based on the decennial liability regime arguing that the power plant boiler is an essential part of the WtE plant; the use of defective material rendered the WtE plant useless.

## 4. Liquidated damages versus contractual penalties

In practice, it may be extremely costly and time consuming to prove that a specific defect, a failure to achieve certain milestone dates, performance parameters or availability requirements has led to a specific damage. Therefore, it has become a standard practice in international project agreements to include contractual mechanisms such as *liquidated damages* or *contractual penalties* for delay, performance and availability aiming at overcoming such difficulties. However, there are various differences between liquidated damages and contractual penalties in terms of both, content and effectiveness requirements, which should be carefully assessed under the jurisdiction involved in order to avoid the invalidity of the clauses involved.

Liquidated damages are understood as an anticipated loss pre-estimate for the minimum damage under the contract resulting from the act to be cured on a *liquidated basis* – e.g. anticipated delay damages per day according to the underlying financial model; performance damages per MWh in case of a shortfall. Since by this clause only the amount of damages is generalized – e.g. for the typical default situation – the opposing party must still prove the grounds of the claim ie. the general existence of the obligation to pay compensation in every individual case (= no shifting of the burden of proof regarding all other conditions of entitlement).

However, liquidated damages need to be differentiated from contractual penalties. While liquidated damages aim at simplifying the enforceability of a certain claim, contractual penalties aim at penalizing a certain behavior. Ultimately, the intention of a contractual penalty is to put such a high burden and pressure on the obliged party that it will do its best to fulfill its obligation and to avoid that the penalty is triggered. Accordingly, the amounts to be paid under contractual penalty clauses do not represent an anticipated loss pre-estimate but a much higher amount determined by the beneficiary of the clause.

In common law systems, contractual penalties are widely prohibited and liquidated damages concepts have been introduced as reaction to such prohibition[8]. As a consequence, if a clause is categorized as contractual penalty, it will be void and statutory law will apply. This means that the beneficiary of the respective clause will not benefit from its content at all and it will have to prove that a certain defect, act, omission etc. has led to a certain to be evidenced damage – in reality, this will lead to a costly and long-term litigation or arbitration, which should be avoided. Therefore, careful consideration needs to be given to the wording of such clauses in order to ensure that a valid liquidated damages and not an invalid penalty clause has been agreed (in common law systems).

[8] Dunlop Pneumatic Tyre Co. v New Garage and Motor Company, H.L.(E.) 1914, 79; Klee, International Construction Contract Law, p. 28; Day, J.B.L. 2014, 512, 513; Richardson, Edin. L.R. 2015, 119, 121; O'Sullivan, C.L.J. 2014, 480, 483; Peel, L.Q.R. 2014, 365, 366 et seq. One of the major differences between Civil contract law and Common contract law is the different views on penalties and liquidated damages. In Civil law jurisdictions, penalties are generally enforceable but their amount may be restricted, e.g.: France: Article 1152 du Code Civil; Belgium: Article 1226 ff. Code Civil; Germany: §§ 341 et seq. German Civil Code; Switzerland: Article 163 Code of Obligations.

In the landmark case of *Dunlop Pneumatic Tyre Co*[9] the court sets out the basic principles that determine when a clause is a liquidated damages clause, and when it is an unenforceable penalty. It established that, in order to be enforceable, the sum payable on a breach must represent a genuine pre-estimate of loss. The parties are bound by this estimate, irrespective of the actual loss suffered. However, the line between liquidated damages and penalties is thin. English courts used a rigid course to determine unenforceable penalties.[10] In their opinion, penalties violate the private autonomy by putting unreasonable pressure on the other party. The courts expressed that the main purpose of penalties is to penalize the other party for a breach of contract. Hence, the other party will only fulfill the contract in fear – in terrorem – of the possible penalty. Consequently, many clauses being supposedly liquidated damages were in fact unenforceable penalties.

- As a summary, the English case law sets out the principles for assessing whether a clause is enforceable as a genuine pre-estimate of loss or unenforceable as a penalty:
- A liquidated damages clause is *a genuine covenanted pre-estimate of damage*, even if it is unable to precisely estimate future loss;
- A clause is a penalty if the sum is *extravagant and unconscionable* in comparison with the greatest loss that could follow from the breach; and
- A clause is presumptively a penalty if a single lump sum is payable on the occurrence of one or more or all of several events.[11]

These criteria were much discussed, further developed and lately heavily criticized.[12] A recent decision of the UK Supreme Court took, however, a more tolerant approach.[13] This is driven by the conviction that the penalty rule does prohibit economically reasonable clauses with drastic consequences on the contractual risk allocation. The new test takes the *fairness* and *reasonableness* elements stronger into consideration. The central question is whether the clause violates economic interests of the injured party as well as its reasonableness.[14] The clause is an enforceable liquidated damages clause and not a contractual penalty one if the clause serves a legitimate economic purpose and it is not extravagant, exorbitant or unreasonable to the secured economic interests.[15]

9 Dunlop Pneumatic Tyre Co [1915] AC 79.

10 Dunlop Pneumatic Tyre Co. v New Garage and Motor Company, H.L.(E.) 1914, 79, at para. 87; Day, J.B.L. 2014, 512, 515; Richardson, Edin. L.R. 2015, 119, 121.

11 Dunlop Pneumatic Tyre Co Ltd New Garage and Motor Co Ltd [1915] AC 79 (HL).

12 United International Pictures v Cine Bes Filmcilik VE Rapimcilik [2003] EWCA Civ 1669; Murray v Leisureplay Plc [2005] EWCA Civ 693; Clydebank Engineering and Shipbuilding Company Limited v Don Jose Ramos Ysquierdo y Castaneda [2005] AC 6; Lordsvale Finance PLC v Bank of Zambia [1996] QB 752; Alfred McAlpine Capital Projects Ltd v Tilebox Ltd [2005] Build. L. R. 271 (TCC); Peel, L.Q.R. 2014, 365, 366; Tall, Ent. L.R., 2013, 146, 148.

13 UKSC 2013/0280 Cavendish Square Holding BV v Talal El Makdessi.

14 UKSC 2013/0280 Cavendish Square Holding BV v Talal El Makdessi at para. 32.

15 UKSC 2013/0280 Cavendish Square Holding BV v Talal El Makdessi at para. 99; Azimut-Benetti Spa (Benetti Division) v Healey [2010] EWHC 2234 (Comm), at para. 19; Court of Appeal Cavendish [2013] EWCA Civ 1539; [2014] B.L.R. 246, at para. 104; Peel, L.Q.R. 2014, 365, 366; Tall, Ent. L.R., 2013, 146, 148.

It is still unclear how the courts will interpret these new criteria on a broad basis. However, especially if the parties negotiated with equal bargaining power and were supported by legal advisors, courts *are predisposed … to uphold [liquidated damages clauses]. This predisposition is even stronger in the case of commercial contracts freely entered into between parties of comparable bargaining power*.[16] This reflects the English legal tradition of empowering the parties' contractual will and their respect for the private autonomy.

Nonetheless, the injured party can still not rely on a valid liquidated damages clause if the punishment of the violating party is the sole reason of the clause. A clause which is only driven by such purpose is, however, very rare in international construction contracts. In contrast, the employer's interests in an on-time delivery – i.e. on scheduled commercial operation date – and the conformity of the works with the contractual scope are likely to be valid interests. It should be noted again that where a liquidated damages clause is held to be an unenforceable penalty, the party seeking payment will nonetheless be able to claim its actual loss.[17] In this case, the party bears the burden of proof. Additionally, the application of the penalties rule extends beyond clauses which refer to the payment of a specified amount of money. English courts have held that clauses providing for something other than the payment of money are capable of being penalty clauses, e.g. withholding payment upon breach of contract; the transfer of shares back to the injured party at a fixed price (which was at an undervalue), upon the contract breaker's failure to make a payment;[17] a clause requiring a contract breaker to forfeit a deposit or sum of money due or to become due to the other party in the event of a breach.[18] The question is, therefore, in each case, whether the penalties rule applies to that particular clause.

In contrast to common law based systems and according to various civil law systems, contractual penalty clauses are not generally ineffective and unenforceable, e.g. under German law. However, the effectiveness/validity of both, liquidated damages (*pauschalierter Schadenersatz*) and contractual penalties (*Vertragsstrafen*) is limited by a strict regulation, especially with regard to German law on general terms and conditions. Thus, a liquidated damages clause is only effective in case it allows the party obligated to pay damages to prove that the actual damage is lower than the amount due under the liquidated damages clause. Contractual penalty clauses are especially void if the penalty is to be paid in the event of non-acceptance or late acceptance of the performance, payment default or termination (*Rücktritt*) by the other party. However, the validity of liquidated damages and contractual penalties clauses should be assessed on a case by case basis. Any *unliquidated* damages can exceed the amount of the liquidated damages. If contractually agreed upon, the employer may prove that its actual damage is higher than the amount of liquidated damages. In case such right to prove higher damages is not explicitly agreed upon, the liquidated damages, however, provide a complete remedy.

[16] Alfred McAlpine Capital Projects Ltd v Tilebox Ltd [2005] Build. L. R. 271 (TCC); cf. also Phillips Hong Kong Limited v The Attorney General of Hong Kong [1993] 61 BLR 49 at 59; Murray v Leisureplay Plc [2005] EWCA Civ 963, [2005] I.R.L.R. 946.

[17] Jobson v Johnson [1989] 1 WLR 1026.

[18] Workers Trust and Merchant Bank Ltd v Dojap Investments Ltd [1993] AC 573.

**Case Study**

An international construction company entered into an EPC contract for the turnkey construction of a WtE facility in Turkey. The parties agreed that the contract shall be subject to English law and that the International Chamber of Commerce (ICC) arbitration rules shall apply in case of disputes.

Due to a delay of the boiler sub-contractor, the commercial operation date occurs six months following the scheduled commercial operation date. The employer claims delay liquidated damages under the respective contractual clause amounting to USD 8 million.

The EPC Contractor rejects payment. During the following arbitration proceedings it argues that the agreed damages were not based on the employer's economic interests but are unreasonable and penalizing only. The appointed arbitration tribunal rejects this argument. It stipulates that the delay damages are reasonable compared to the expected and suffered damage and that they serve a valid economic interest.

## 5. German law on general terms and conditions (*AGB*)

Over the last few years, there is a trend in the international construction market to avoid German law contracts, when possible. Even some of the German major contractors have moved away from the application of German law in their standard agreements for the benefit of other jurisdictions such as Switzerland or England and Wales. This development is particularly driven by the strict German regime on general terms and conditions, following which the German Federal Court of Justice (*Bundesgerichtshof – BGH*) has established high hurdles for the valid agreement of various important clauses in project/construction agreements. For example, under German law the validity of limitation of liability clauses, liquidated damages clauses and contractual penalty clauses is disputed, if such clauses have been agreed as general terms and conditions (*Allgemeine Geschäftsbedingungen – AGB*) and not as usually valid and individually negotiated clauses (*Individualvereinbarung*).

However, these risks do not only apply to construction contracts, but also to a wider range of contractual arrangements in the WtE sector. For example, German waste supply agreements are regularly based on gate fees and comprise bring-or-pay clauses. Under German law, the validity of bring-or-pay clauses is strongly disputed, if they have been agreed as general terms and conditions.

Instead of relying on the private autonomy of professional parties, which negotiate with substantially equal bargaining power, understand the risks they may take and are supported by legal advisors, German courts often apply the German laws on General terms and conditions (*Allgemeine Geschäftsbedingungen – AGB*) and declare the respective clauses invalid – although the German AGB laws historically have been developed to secure consumers against considerably stronger counterparties.

The legal background is as follows: The party introducing a clause into negotiations is almost always classified as a *user* of general terms and conditions (AGB) for this clause and the German laws on general terms and conditions will apply to this clause accordingly. In the event that a user of such a limitation of liability clause becomes involved in a dispute with the other party regarding the validity of the clause, the user of the clause will bear the burden of proof that the clause is not an AGB provision – and not void. In practice and with regard to a significant number of precedent judgments, this is extremely difficult to be proved.

Once a clause has been classified as an AGB, the provision will be ineffective if, contrary to the requirement of good faith, it unreasonably disadvantages the other party to the contract with the user (*reasonableness test*). An unreasonable disadvantage may also arise from the provision not being clear and comprehensible. An unreasonable disadvantage is, in case of doubt, to be assumed to exist if a provision is not compatible with essential principles of the statutory provision from which it deviates, or limits essential rights or duties inherent in the nature of the contract to such an extent that attainment of the purpose of the contract is jeopardised, cf. sec. 307 para 1,2 German Civil Code.

However, it should be noted that under the reasonableness test, many limitations of the general concepts set by law – which will usually not represent the will of the parties – are (for the user of the clause) not allowed according to German law. For example, under a German law based limitation of liability clause, the exclusion of *gross negligence* and *personal injury* for the benefit of the clause-user is prohibited. Additionally, an exclusion of liability for breach of contractual cardinal obligations (*Vertragliche Kardinalpflichten*) is not possible even with respect to slight negligence.

If just one AGB-related ineffective component is included in a clause, there is always a risk that the entire liability clause will be considered to be ineffective. However, the invalidity might be reduced to the critical part of it, if this part can be separated from the rest of the provision and the provision remains applicable and complete without the invalid part. Therefore, care must be taken with the wording in the contract design and it must also be noted that a high invalidity risk may exist. This needs to be assessed individually for each contract. Otherwise, in case of an invalid clause agreed in general terms and conditions, German statutory law will apply and the contractual counterparty will be entitled to claim on an unlimited basis, regardless of the contractual will of the parties.

From a best practice perspective, there are various ways to face the aforementioned issues regarding the potential invalidity of the contractually agreed clauses. Two quite common approaches are set out below: One possibility is to make a contractual agreement subject to foreign law with less strict liability standards and standards regarding general terms and conditions – e.g. Swiss law, cf. above. It has also been argued that the parties may agree on an arbitration clause and under this arbitration clause agree on German law just with the exception of the AGB law. Admittedly, this may be considered to be in breach of *ordre public*. However, such solutions have to be checked on a case-by-case basis and are usually not possible in projects related to the German public sector.

Alternatively, it may be avoided being a *user* of AGBs under German law, for instance by not introducing an *own* clause wording into the contractual negotiations, but by negotiating an existing wording provided by the counterparty relating to the same content – e.g. limitation of liability, liquidated damages, bring-or-pay etc. In this case, the party looking for protection by the clause in question, may not be classified as a user of AGBs and the strict AGB law will solely apply at the expense of the counterparty, with the consequence that all regulations in favour of the *user* will not be checked for their effectiveness. In the event that the counterparty's draft contract does not contain wording relating to the desired clause, there is no other option but to insert a new clause. The only possibility in this case is to ensure – in the capacity as a user of the clause – from the beginning that sufficient documentation is in place to prove that the disputed clause has been individually negotiated (*individualvertraglich*). Such an individually negotiated clause does not constitute an AGB and, accordingly, a reasonableness test will not apply. For this proof of negotiation as a last recourse, it is essential that the user of the clause documents that he has seriously placed the clause at the counterparty's disposal. However, it is important to note that the Federal Court of Justice has drawn up hardly achievable hurdles for such proof in practice, and that a high risk of ineffectiveness cannot be prevented.

**Case Study**

An operator of WtE facilities considers erecting an additional WtE plant and enters into a long-term waste supply agreement with a private waste collector in order to secure the required waste volumes for the new plant. The agreement contains a clause under which the supplier is obliged to pay a pre-agreed remuneration for shortfall quantities if such quantities cannot be subsequently delivered within a certain period of time.

Following erection of the WtE plant and the agreement taking effect, 4 years later, the waste supplier falls short of the contractually agreed waste volumes by 30.000 tons per year.

The operator claims damages under the above mechanism and the waste supplier claims that the clause is invalid due to an inappropriate disadvantage to the operator.

The competent court considered the clause as invalid. It stated that the respective bring-or-pay obligation was not part of the contractual exchange and served only for the purpose of securing the full utilization of the plant. Additionally, the disadvantages resulting from the clause were not compensated by other stipulations of the agreement.

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