

TIME IS (LITERALLY) MONEY

Liquidated Damages

a quick guide to defenses and negotiating contracts

By Luke J. Farley and Dixie T. Wells

“Liquidated damages”—the term strikes fear into the hearts of contractors. Liquidated damages, or LDs as they are often called, are monetary damages imposed by the owner for late completion of a project. The parties agree to liquidated damages in the construction contract, which provides a daily rate that continues to accrue each day the project is late, ticking away day by day, until the contractor achieves substantial completion. On the largest projects, it is not unusual for liquidated damages to be in the tens or hundreds of thousands of dollars per day. Given the potential exposure that comes from liquidated damages, it is no wonder liquidated damages clauses are some of the most negotiated provisions of any construction contract. This article provides an overview of liquidated damages, defenses contractors can raise to claims for liquidated damages, and key points to consider when negotiating contracts.

Liquidated damages are intended to compensate the owner for late completion. Oftentimes, it can be difficult to determine the financial loss

from late completion, so the owner and the contractor agree to “liquidate” (i.e., make certain) the owner’s damages by agreeing to a daily rate of damages that will be assessed for each day the project is late. These damages are intended to compensate the owner for lost revenue, additional financing charges, etc., that occur when a project is not finished on time.

DEFENSES

For contractors, there are two key defenses to liquidated damages. First, the daily rate of damages cannot be a penalty. Most parties think of liquidated damages as a penalty for late completion, but under the law the purpose of liquidated damages is compensation, not punishment. In order for a liquidated damages clause to be enforceable, the rate must bear some reasonable relationship to the actual monetary losses the owner would suffer from late completion. For instance, a rate of \$20,000 per day for late completion of a modest single-family home would likely be viewed by a court as an unenforceable

penalty, because it far exceeds the actual damages that result from not finishing the home on time.

The second key defense to a claim for liquidated damages is known as “concurrent delay.” Concurrent delay occurs when both the owner and the contractor cause delays to the critical path of the work at the same time. (Sequential delay, a related concept, occurs when the owner and the contractor both delay the critical path but do it one after the other and not at the same time.) Under the law in most states, unless specifically addressed in the contract, concurrent delay is a complete defense to a claim for liquidated damages. In other words, if the contractor can show that the owner was also responsible for delays to the project—like failing to respond to RFIs in a timely manner—then the contractor can avoid the liquidated damages.

While contractors are often quick to assert concurrent delay, proving it is another matter. It can be difficult, after the fact, to demonstrate that the owner was also causing delays

to the critical path. Contractors can set themselves up for a successful concurrent delay defense by maintaining good, contemporaneous project records, carefully documenting owner-caused delays, and, perhaps most importantly, using a critical path method (CPM) schedule and updating it frequently throughout the project to show the as-built schedule of the work.

NEGOTIATING

If an owner insists on including liquidated damages in a contract, contractors should consider these negotiating points to make the clause more balanced and minimize exposure.

1 SKIP THE LIQUIDATED DAMAGES ALTOGETHER

When both parties know liquidated damages will be ticking away, it raises the tension on the project. The parties will act defensively and feel the need to carefully document delays and put

each other on notice of all potential delay claims no matter how seemingly insignificant. Suggest to the owner that the parties skip LDs to promote harmony and cooperation on the project. A savvy owner might recognize the harm that does to the working relationship with the contractor and agree to skip the LDs all together.

2 CAP LIQUIDATED DAMAGES

Most commercial construction contracts include a mutual waiver of so-called "consequential damages" which covers things like lost rent, lost profit, etc. Liability for consequential damages could be ruinous for the contractor and often means the risk of the contract outweighs the reward for the contractor. But a liquidated damages clause can be an end-run around a waiver of consequential damages, allowing practically unlimited recovery for late completion. To ensure the contractor is not inadvertently exposed for the open-

ended consequences of late completion, consider negotiating a cap on the total amount of liquidated damages the owner can assess. One fair option is to cap the liquidated damages at some percentage of the contractor's fee or anticipated profit.

3 ALLOW A GRACE PERIOD

Liquidated damages typically start to accrue when the contractor fails to achieve substantial completion within the contract time—but they do not have to start then. One option to take some pressure off the contractor is to allow a grace period—usually between 14 and 30 days—before the LDs start. This effectively pushes the substantial completion date out by the length of the grace period. Beware, an owner who knows how to negotiate a construction contract might agree to a grace period but will probably seek to make the liquidated damages retroactive if the contractor does not finish within the grace period.

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In other words, if the contractor is able to finish within the grace period, then the contractor is not liable for any liquidated damages. But if the contractor cannot finish within the grace period, then the contractor is liable for all liquidated damages that accrued, even during the grace period. This prevents the grace period from becoming a mere extension of the substantial completion date.

4 CONSIDER TIERED LIQUIDATED DAMAGES

Not all delays are created equal. Whether a project is 3 days late or 30 days late can make a big difference to the owner and that should be reflected in the liquidated damages. To lessen the impact of a relatively brief delay, the parties can agree to tiered liquidated damages, where the daily rate increases as more time passes.

5 MAKE LIQUIDATED DAMAGES THE OWNER'S SOLE REMEDY FOR DELAYED COMPLETION

If the owner is going to insist on liquidated damages, then the liquidated damages should be the owner's only relief for late completion. Owners will sometimes try to claim both liquidated damages and other damages arising from late completion. The liquidated damages clause should state clearly that if the project is late, the owner's only recovery against the contractor is liquidated damages.

6 FLOW DOWN LIQUIDATED DAMAGES TO SUBCONTRACTORS

Getting hit with liquidated damages is bad for a contractor, but not being able to pass the LDs down to subcontractors is worse. Contractors must make sure that there is a similar liquidated damages clause in all their subcontracts so that subcontractors can be held responsible for any liquidated damages caused by the subcontractors. This includes coordinating any caps on liquidated damages. For instance, if LDs are capped in both the prime contract with the owner and the subcontract with the

subcontractor, the contractor may still be exposed to the owner for LDs if, for example, the prime contract caps LDs at 15% of the overall prime contract price but subcontract caps LDs at 15% of the subcontract price (which presumably is much smaller than the overall prime contract price with the owner).

CLOSING THOUGHT

Liquidated damages remain an owner's best tool for inducing the contractor to complete the work on time. While most contractors will find it difficult to completely negotiate away liquidated damages clauses, they can lessen their impact by negotiating compromise language that makes the clauses more balanced and less onerous. If a contractor gets caught in a fight over liquidated damages, it can increase its chances of prevailing by documenting the progress of the work as it happens and keeping good project records. ■

Disclaimer: This article is not legal advice and does not create an attorney-client relationship.

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