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Bulletin #85, Liquidated Damages' Clause for Delays – Friend or Foe? (April 12, 2005)

Construction delays are costly to both owners and contractors alike. Owners may lose use of a facility and/or profits while waiting for a facility to be completed. Contractors must maintain additional personnel and incur additional office expenses for a delayed project. Despite the costs, delays are not uncommon. Materials and labor shortages are just two examples of things that can cause construction delays.

In addition to the costs inherent in delays, most construction contracts contain a "liquidated damages' clause," which attempts to quantify the cost of delays or breaches of contracts. A liquidated damages' clause is a contract provision, which specifies the amount of compensation for delay damages.

The Basics

Liquidated damages' clauses are included in the majority of construction contracts and generally represent a *per diem* amount that will be withheld from the contractor for each day the project completion is delayed. In order to be enforceable, the liquidated damages must be reasonable in light of the anticipated or actual losses. A liquidated damages' clause will be considered reasonable if it is a reasonable estimation of the owner's actual damages. The key focus is whether the amount is reasonable at the time the parties enter into the contract. Liquidated damages' clauses are likely to be upheld if it is difficult to determine actual losses.

A liquidated damages' clause **will not** be upheld if it appears to be a penalty clause. The clause must be an estimate of the actual damages that will be suffered and cannot be used to coerce a contractor into meeting a deadline or punish a contractor for missing a deadline. One way to think of the difference between a penalty clause and a liquidated damages' clause is to consider that the purpose of a penalty clause is to secure performance, while a liquidated damages' clause is simply designed to represent an amount to be paid in the event of non–performance. However, practically speaking, this is a difficult distinction to identify. A liquidated damages' clause is not a penalty clause simply because the owner hopes it will encourage prompt performance. In fact, it is an appropriate means for inducing performance. However, such a clause will be struck down if its **only** purpose is to spur performance and it simply amounts to a punishment for a breach that could produce no possible damage.

History of Enforcement

The courts have been enforcing liquidated damages' clauses for at least one hundred years. Liquidated damages' clauses have been upheld even in situations where there was no actual damage suffered as a result of the delay. In fact, the trend toward acceptance of liquidated damages' clauses was recognized by the United States Supreme Court as early as 1907.

> [C]ourts . . . have now become strongly inclined to allow parties to make their own contracts, and to carry out their intentions, even when it would result in the recovery of an amount stated as liquidated damages, upon proof of the violation of the contract, and without proof of the damages actually sustained.

The Supreme Court upheld a liquidated damages' clause, which resulted in a recovery for the United States even though the United States could not demonstrate that it suffered any actual damages as a result of the delay. United States v. Bethlehem Steel Co., 205 U.S. 105, 119 (1907), as cited in Matthew J. Christian, "Public Entities in Nevada Beware: The Liquidated Damages Clause in Your Construction Contract May Be Unenforceable," October 2004. Courts around the country have continued to uphold this general rule. For example, in Public Health Trust of Dade County v. Romart Construction, Inc., 577 So.2d 636 (Fla. Ct. App. 1991), the Florida Court of Appeals upheld a liquidated damages' clause that resulted in an award of $2,500 per day for a 68−day delay. The court found that there was nothing unreasonable about the liquidated damages' clause. The court was not swayed by the contractor's argument that there was no actual monetary loss resulting from the delay.

Defenses to a Claim for Liquidated Damages

In light of the fact that delays are commonplace in the construction industry, you may be asking yourself, "Is there a way I can avoid being charged liquidated damages on a project?" The answer is "yes" – there are defenses that you may be able to raise if you are faced with a claim for liquidated damages.

First, a contractor may be able to argue that the liquidated damages' clause was actually a penalty clause. If you can demonstrate that the amount of the liquidated damages was not a reasonable estimation of the actual damages the owner might suffer, the clause may be viewed as a penalty clause. As discussed above, penalty clauses are not enforceable.

Second, the contractor may also be entitled to additional time under the contract if the delay was excusable. Depending on the language in the contract, excusable delays can encompass a wide variety of situations in which delays arise out of situations that are beyond the contractor's control. These types of delays can include such things as natural disasters, e.g., floods and fires (see *Contracts Bulletin #65 – Force Majeure – A Clause for Our Times*), or delays caused by design problems. Such delays may justify an extension of the deadline for completion of the project. It is important to pay close attention to the contract when determining who is liable for a delay that is seemingly outside the control of either party. In many cases, contracts are drafted in such a manner that justifiable extensions of time are rare.

Third, a contractor may be faced with a situation in which the delay is clearly caused by the owner or another entity under the owner's control. Such delays may take the form of directed change orders, failure to fulfill contractual conditions, or changed conditions. In such situations, not only should liquidated damages not be awarded to the owner, but the contractor should be compensated for its additional costs and given an extension of time to complete the work.

Finally, owner interference is another example of a situation in which a contractor's delay would likely be justified. If an owner takes action, or remains inactive, and interferes with a contractor's performance, an owner may be forced to forfeit any liquidated damages to which it would otherwise have been entitled and may be liable for additional costs incurred by the contractor. Consistent with this rule, some courts have held that an owner, who hires multiple prime contractors, is, itself, charged with the responsibility of coordinating their activities to avoid delay. An owner that fails to effectively coordinate the schedules of multiple prime contractors may be left without a remedy if the contract is delayed.

Using a Liquidated Damages' Clause to the Contractor's Advantage

A liquidated damages' clause could prove to be a contractor's best friend. As stated above, liquidated damages' clauses are inserted into contracts because actual damages are difficult to predict and quantify. As

a result, the parties agree upon a *per diem* amount that is designed to represent the parties' best estimate of the actual damages the owner will suffer as a result of delayed completion. But what happens when it is apparent that the actual damages are significantly greater than the liquidated damages under the contract? Faced with that very situation, many courts have construed the liquidated damages' clause against the owner and limited the owner's recovery.

For example, in Worthington Corp. v. Consolidated Aluminum Corp., 544 F.2d 227, 234–235 (5th Cir. 1976), the Fifth Circuit Court of Appeals upheld a liquidated damages' clause capping recovery at $100,000.00 even though the owner sought actual delay damages in excess of $4 million. Consolidated contracted with Worthington to design and construct an isolated power plant for Consolidated's aluminum manufacturing complex. In the action, Consolidated sought over $4 million in damages from Worthington that allegedly resulted from Worthington's failure to complete the power plant by the date specified in the contract. However, the contract between Consolidated and Worthington contained a liquidated damages' clause. Because of the liquidated damages' clause, delay damages were limited to $500 per day and could not exceed a total of $100,000. The court construed the liquidated damages' clause to be a limitation on Worthington's liability and found that Consolidated's recovery for delay was limited to the amounts set forth in the liquidated damages' clause.

In Metropolitan Dade County v. Frank J. Rooney, Inc., 627 So.2d 1248 (Fla. Ct. App. 1993), the Florida Court of Appeals reached a similar result. In that case, Dade County contracted with Rooney for the construction of a detention center. For various disputed reasons, Rooney did not complete the contract by the scheduled completion date. The contract contained a liquidated damages' clause that was designed to provide protection to Dade County. The clause provided that Dade County could recover $2,500 per day for each day the project was delayed by Rooney. Dade County presented evidence that it suffered in excess of $7 million in actual damages as a result of delays. The court found that Dade County drafted the contract and accepted the liquidated damages' amount. As a result, it was prohibited from introducing evidence of its actual damages.

As a general rule, if a liquidated damages' clause was reasonable at the time the parties entered into the contract, it will also serve to preclude the owner's ability to recover actual damages. However, as with any "hard and fast rule," there are always exceptions. In Northern Petrochemical Co. v. Thorsen & Thorshov, Inc., 211 N.W.2d 159 (Minn. 1973), the Minnesota Supreme Court held that the liquidated damages' clause in the contract was only designed to compensate for "normal" delays. The court found, in that case, the delay of eight months was extraordinary. Consequently, the owner was not limited to the amounts set forth in the liquidated damages' clause but was entitled to recover actual damages including lost profits.

Practical Considerations

When faced with a delay in project completion, it is important for the contractor to pay careful attention to the requirements in the contract. Any specific notice requirements relating to a delay should be strictly followed. In addition, even if there are no specific requirements in the contract, it is advisable to provide the owner with notice of delays. Furthermore, it is always prudent for the contractor to keep careful documentation relating to delays to enable a contractor to argue any available defenses to a liquidated damages' claim. Finally, a decision about whether to devote more resources to a particular project to avoid delay damages may come down to a simple cost vs. benefit analysis. A contractor may determine that it is less expensive to simply pay the liquidated damages rather than pull resources from another project to ensure timely completion.

Conclusion

Although not failsafe, well thought out liquidated damages' clauses may benefit both owners and contractors. Owners can be assured that they have some protection if a project is not completed in a timely manner, and contractors are aware of the extent of their exposure if completion of a project is delayed. It is important to keep in mind that to be enforceable, the liquidated damages' clause must be reasonable. Consequently, it is wise to maintain records of the method used to calculate the liquidated damages' clause

to demonstrate its reasonableness in the event it is later challenged.

(It is important to keep in mind that this *Contracts Bulletin* is only a general overview of the law in this area. Because laws in individual states may vary, it is recommended that you seek competent legal advice.)

SMACNA wants the Contracts Bulletins to serve our members. Your feedback or topic suggestions are welcomed by contacting Steve Yoch (e−mail: syoch@felhaber.com; telephone 651 312 6040) or Tom Soles, SMACNA's Executive Director – Market Sectors, (e−mail: tsoles@smacna.org; telephone: 703 803 2988).

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