

Understanding the Purpose, Limitations, and Benefits of a Liquidated Damages Clause

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Construction contracts, both public and private, often include liquidated-damages clauses, and each contracting party should understand the purpose, limitations and benefits of such clauses. This is particularly true given that, because of the ongoing impact of COVID-19, many construction projects are facing completion delays, possibly triggering liquidated-damages clauses.

What Are Liquidated Damages?

In a contract, parties define their rights and duties and allocate risks. When a party breaches a contract, the non-breaching party may (generally) recover its actual damages resulting from the breach.¹ And when parties agree in their contract to liquidate their damages, they establish an agreed-to amount of damages, e.g., \$1,000 per day of project delay, as a substitute for the actual damages that the non-breaching party may recover as a result of the breach, regardless of the actual damages ultimately suffered.

Why Liquidate Damages?

Rather than having to prove the quantum of a non-breaching party's actual damages, contracting parties can agree to a sum or a rate as a substitute for actual damages. Liquidating damages in a contract limits the time, cost and difficulty of proving or challenging actual damages and, equally importantly, provides the parties with valuable information to use in assessing their risks and in determining what actions to take during construction.

For example, if a subcontract includes liquidated damages of \$1,000 per day of subcontractor-caused delay to the project's critical path, then a subcontractor can use this information to determine how to deal with a potential delay for which it is responsible. The subcontractor can compare (a) the cost of accelerating its efforts to eliminate or reduce the delay to (b) its liability to the general contractor for delaying the project (and the subcontractor's own costs for the delay).

Assuming that the subcontractor can accurately estimate the length of the delay, knowing the daily rate of liquidated damages for delay allows the subcontractor to accurately assess its financial exposure to the general contractor, in turn allowing the subcontractor to more accurately evaluate its risk and weigh its options. In short, having a contractually liquidated cost of delay permits the subcontractor to make an informed decision on whether (a) to breach by delaying completion of the project or (b) to eliminate or reduce the delay by accelerating.

Are the Liquidated Damages a Valid Substitute for Actual Damages or an Invalid Penalty?

While the law generally allows contracting parties to agree on the quantum of damages for a future breach, the law prohibits a liquidated-damages clause that constitutes a penalty. Court-developed law has variously defined the test for determining whether a given liquidated-damages clause is valid, but the highest court in Maryland has provided a standard formulation:

Maryland courts will uphold a [liquidated-damages] clause as valid, and not a penalty, if it satisfies two primary requirements. First, the clause must provide a fair estimate of potential damages at the time the parties entered into the contract. Second, the damages must have been incapable of estimation, or very difficult to estimate, at the time of contracting. *Barrie School v. Patch*, 401 Md. 497, 510 (2007).²

The two-part test for determining whether a liquidated-damages clause is valid establishes the roadmap for challenging the validity of such a clause. Even though parties may have signed a contract that includes a liquidated-damages clause, a party generally retains the right to challenge the validity of the clause in court.³

Most often, the breaching party — the party that would pay under the liquidated-damages clause (typically, the lower-tier party) — challenges the validity of the liquidated-damages clause, arguing that, at the time of contracting, the liquidated damages were not a fair estimate of the potential damages or that the damages were capable of estimation, or both, and that the liquidated damages overcompensate the non-breaching party. If the clause fails either element of the validity test, then the clause is invalid. If the clause is invalid, then the non-breaching party is not without recourse; while it cannot recover the agreed-to (liquidated) damages for a breach, it may still seek to recover its actual damages.

But at times, the non-breaching party — the party that would receive payment under the liquidated-damages clause (typically, the upper-tier party) — seeks to invalidate the clause, usually arguing that the agreed-to damages undercompensate it for the damages resulting from the breach.

The analysis of whether a liquidated-damages clause is a penalty because it overcompensates the non-breaching party is fundamentally different from the analysis of whether a liquidated-damages clause undercompensates the non-breaching party, the latter analysis generally turning on whether the clause is unconscionable. Failing to understand and apply the different public-policy reasons behind these two arguments can be fatal to a contracting party's position when faced with the (uncommon, but not unheard of) argument that a liquidated-damages clause is invalid because it is undercompensatory.

Has a Party Waived its Right to Challenge the Validity of its Liquidated-Damages Clause?

While the law of each jurisdiction prescribes the requirements for a valid liquidated-damages clause — which requirements define how one might attack a liquidated-damages clause as invalid — some contracts provide that one or both of the parties waive the right to challenge the clause as invalid. If a court enforces such a waiver to challenge the validity of a liquidated-damages clause, then whether the liquidated-damages clause would otherwise be valid is irrelevant. Agreeing to a liquidated-damages clause that one thinks is unenforceable with the hope of later challenging it as unenforceable is a risky endeavor, first, because one might not be able to establish that the clause fails to comply with legal requirements and, second, because one may have waived the right to challenge the clause's validity.

What Actual Damages Does the Liquidated-Damages Clause Liquidate?

Liquidated damages serve as an agreed-to substitute for actual damages. And a contract should clearly identify what specific, or categories of, damages the parties are liquidating.

In construction contracts, delay damages are the most commonly liquidated category of actual damages. But it is critical to understand whether a contract liquidates the entirety of the non-breaching party's delay damages or only subcategories of delay damages. For example, in constructing a hotel, the project owner might expect to suffer various types of damages from the contractor's delay, including, among others, lost revenue, increased loan costs, standby costs for hotel staff, delay costs of the owner's separate contractors, storage costs for owner-furnished equipment and additional franchisor-inspection costs. If the parties agree to liquidate delay damages, then they should clearly spell out in the contract whether the liquidated damages cover all damages from delay or only selected subcategories of delay damages (and which ones).

Although the non-breaching party cannot recover both liquidated damages and the actual damages that the parties liquidated, merely agreeing to liquidate one category of damages does not by itself bar the non-breaching party from recovering actual damages for other categories of damages that the parties did not liquidate.

Have the Parties Sought to Accurately Estimate Potential Damages?

Because a prospective analysis of a liquidated-damages clause evaluates whether the liquidated-damages amount was a "fair estimate of potential damages at the time the parties entered into the contract," a party should make a serious effort to accurately estimate the potential damages it seeks to liquidate. This effort should involve individuals familiar with the party's accounting and financial records and, depending on the magnitude of potential damages, a party should consider hiring a consultant experienced in estimating construction costs. A front-end thorough, accurate, and documented analysis helps insulate a liquidated-damages clause from a back-end challenge to the clause as an unenforceable penalty.

Liquidating damages in a contract limits the time, cost and difficulty of proving or challenging actual damages and, equally importantly, provides the parties with valuable information to use in assessing their risks and in determining what actions to take during construction. Contracting parties should understand the purpose, limitations and benefits of such clauses.

1. Actual damages are generally, but not always, recoverable. For example, the contract might expressly bar the recovery of certain damages. And even if the parties have not waived consequential damages, the non-breaching party may only recover consequential damages under limited circumstances.
2. Some jurisdictions differ over the time frame from which the court evaluates the reasonableness of the liquidated-damages amount. While Maryland courts take a "prospective" approach to determining the validity of a liquidated-damages clause — evaluating whether the liquidated-damages amount was a reasonable estimate of damages at the time of contract formation — other jurisdictions use a "retrospective" approach, comparing the liquidated-damages amount to the amount of damages actually suffered by the non-breaching party. It is important to know which approach applies in evaluating the liquidated-damages clause at issue.
3. As discussed below, some courts enforce a party's waiver of the right to challenge the validity of an agreed-to liquidated-damages clause.

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