The Use and Abuse of Liquidated Damages

Liquidated damages are widely used in construction contracts—so widely used that many contractors may lose sight of legal defenses available to an assessment of liquidated damages. Perhaps the best practical defense to liquidated damages is a bid contingency covering any likely delay. On time completion then provides the equivalent of an early completion bonus. But competition may make it difficult to provide an adequate contingency and still win an award. In such instances, it is good to be aware of legal defenses that can be asserted at the time damages are threatened or assessed.

Liquidated damages substitute a predetermined amount for actual damages. Liquidated damages in construction contracts are primarily assessed for unexcused delays in achieving substantial completion and are set in dollars per unit of time, usually days, but sometimes weeks or months. The use of liquidated damages arose before the advent of modern CPM scheduling and the use of CPM scheduling techniques to analyze responsibility for delays. To prevent abuse of liquidated damages, courts have imposed a requirement that liquidated damages be based on a reasonable precontract estimate of actual damages that would otherwise be difficult to prove. Liquidated damages that substantially exceed a reasonable estimate can be deemed an unenforceable penalty. Liquidated damages on a construction project normally stop at substantial completion. Once a project can be used for its intended purpose, any ongoing delay related damages an owner might incur before final completion should be reasonably easy to calculate and, therefore, not appropriate for liquidated damages.

Liquidated damages that are based on a reasonable estimate of likely actual damages serve a useful purpose for both owners and contractors. Specifying a predetermined amount per day, or week, or month of delay relieves the project owner from the risk of being unable to prove actual damages. At the same time, competition permitting, it allows a contractor to factor into its bid the likely cost of an unachievable contract completion date. For both contractors and owners, liquidated damages may reduce somewhat the complexity of resolving delay related disputes. Still, most contractors probably do not view liquidated damages as a blessing. What defenses can a contractor raise to assessment of liquidated damages? If delay is foreseeable, and competition does not allow a contingency, an excellent defense is to not bid the project. Still, even cautious contractors may occasionally be hit with a claim for liquidated damages. Then is the time to think about legal defenses.

Bar none, the best legal defense to liquidated damages is a time extension. The next best defense is to show that the owner is responsible for concurrent delay. Both these defenses take the issue of damages off the table. What if neither is available? Argue penalty. Many modern courts are predisposed to uphold freedom of contract, including the freedom to agree to liquidated damages. But there is tension between the law governing formation of contracts and law governing award of damages. Damages for breach of contract are supposed to put the non-breaching party in the same position they would have been in if the contract had been performed. Liquidated damages that substantially exceed actual damages violate this principle. One clue as to whether the owner has suffered actual
damages may lie in whether the owner is reluctant to accept the work. An owner that drags its feet on accepting beneficial occupancy may not be suffering from the delay. In such a case, it may be likely that liquidated damages are disproportionate to actual damages. An astute contractor may discern other clues indicating that an owner is not suffering damages proportionate to liquidated damages being assessed. In some instances, the owner, if asked, may offer to reduce its claim to actual damages, such as ongoing engineering fees. If at all possible, it is in the contractor’s interest to negotiate damages without resorting to litigation or arbitration. Both litigation and arbitration should offer ample opportunity to investigate the owner’s actual damages, but the process can be very expensive.

While most contracts cut off liquidated damages at substantial completion or beneficial occupancy, some contracts specify liquidated damages for delay in achieving final completion. This can be especially problematic for a contractor. An owner who has the beneficial use and occupancy of a project may have little incentive to accept final completion and could seek to use liquidated damages as leverage to obtain additional maintenance or changes to the work. Just the inclusion of such a provision should give a contractor cause to consider before bidding the contract. If caution fails and time or concurrent delay are not available, then penalty is again the best option. And the defense may be more readily available. It is not happenstance that most contracts cut off liquidated damages at substantial completion. Once the owner has beneficial occupancy of its project, any ongoing damages caused by delay are likely to be limited and easily quantifiable. It necessarily follows that significant liquidated damages are much more likely to be a penalty rather than a reasonable estimate of actual damages.

Project owners may also want to think carefully about the use of liquidated damages. In circumstances where project delay is likely to cause damages that will be difficult to quantify, liquidated damages based on a reasonable estimate can be a very useful tool. On the other hand, liquidated damages that do not meet these criteria may unnecessarily reduce competition, drive up prices, and result in avoidable litigation. Project owners, particularly those who frequently do projects, may find that restrained use of liquidated damages is in their long-term best interest.

Construction contracts frequently specify liquidated damages. To the extent that inclusion of liquidated damages comes to standard practice rather than a project-by-project decision, this can be bad for both contractors and project owners. Liquidated damages can serve the interests of both project owners and contractors. They can also do a disservice to both. Careful, project-by-project consideration may be the best policy.