Liquidated Damages

BY, JOE BASHAM*

I. What’s at stake?
A liquidated damages clause is a stipulation between contracting parties that establishes the amount of damages in the event the contract is breached by failing to complete the project on time. Liquidated damages are usually determined on a per-day basis. While it is rare for a design professional to be subject to a liquidated damages provision, it is possible if your agreement contains a design schedule. More frequently, a design professional may become involved with a liquidated damages provision when the client requests an assessment of the contractor’s delays to the project schedule and the amount of liquidated damages to be imposed on the contractor.

II. Key issues

Purpose. It is often difficult at the beginning of a project to determine the amount of potential damages in the event the project is delayed. Clients routinely request a liquidated damages provision to deal with this uncertainty contractually. Liquidated damages clauses are common in government public works projects where delays may cause damages that are virtually impossible to quantify. By including a liquidated damages clause in its contracts, the client can hold others accountable for delays without the tedious exercise of proving its actual damages.

Enforceability. To be enforceable, liquidated damages provisions must be a reasonable approximation of the probable loss that a client will suffer if performance is delayed, and the actual damages caused by the delay must be difficult or impossible to determine. Courts will determine the enforceability of the clause by considering the circumstances at the time the contract was signed, not when the project is finally completed. Liquidated damages must be contained in the written contract; they will not be implied. Courts look for evidence that the damages provision was negotiated on a project-specific basis. The more specific and tailored a liquidated damages provision is worded, the more likely that it will withstand a challenge to its validity.

Not a Penalty. A liquidated damages clause will be unenforceable if it is considered a penalty. Clauses that attempt to charge an excessively large, lump-sum amount are more likely to be deemed an unenforceable penalty. In an attempt to improve the chances of enforceability, many clients specifically state in their liquidated damages clause that it is not a penalty clause. However, the inclusion of such language is not necessarily controlling. Though it may carry some weight that the parties agreed to bind themselves to a liquidated damages clause, a court will ultimately determine whether or not a clause is enforceable using the factors mentioned in the previous paragraph.

Triggering Mechanism. A liquidated damages clause must clearly specify when the damages begin to accrue. This triggering mechanism can occur at any point in the project that the parties agreed upon. Interim milestones or dates for substantial or final completion are typical triggering mechanisms for liquidated damages.

No Damages Necessary. Generally, a client does not need to prove it has sustained actual damages in order to recover liquidated damages. Most jurisdictions view the reasonableness of a liquidated damages provision by looking at the potential damages that a party could have incurred, as viewed from the information available to the parties when they executed the contract. (Texas is an exception to this general rule and a court may introduce into evidence the fact that a client incurred no actual damages. The absence of damages or a gross disparity between actual and liquidated damages may cause a Texas court to view the liquidated damages clause an unenforceable penalty.)

Election of Remedies. If a contract contains an enforceable liquidated damages provision, that clause will control the amount of damages a client may recover. A client cannot waive a liquidated damages provision because it believes it could recover more by seeking actual damages. A liquidated damages provision, however, may not prevent a client from recovering other costs outside of the scope of the breach referred to in the liquidated damages clause. In fact, some clients draft a liquidated damages provision to
address more nebulous damages such as lost profits or loss of use, but keep more measurable damages, such as added home office overhead, outside of the scope of the liquidated damages provision.

**No Bonus Provision Necessary.** It is not uncommon to include both a liquidated damages clause and a bonus provision for completing the project on time and within budget. A bonus provision, however, is not required. Liquidated damages clauses and bonus provisions may exist without the other. In fact, the opposite of a bonus provision is a penalty clause, which is generally not enforceable.

**Substantial Completion.** As a general rule, liquidated damages cannot be assessed for work performed after substantial completion of a project. This is because a contractor’s failure to perform work after substantial completion (e.g. punch list, repair work, or warranty work) does not interfere with a client’s beneficial occupancy of the project. The client may, however, be able to recover liquidated damages incurred prior to substantial completion and actual damages sustained after substantial completion.

**Final Payment.** Final payment by the client can waive a claim for liquidated damages. Liquidated damages are presumed to be monies deducted from the contract sum, and typically at final payment. The client’s issuance of final payment may constitute a waiver of any claims for liquidated damages.

**III. Negotiating points**

Explain to your client that liquidated damages are not appropriate for all projects. When completion of the work by a date certain is paramount, a liquidated damages provision is a useful incentive to maintain the project schedule. Similarly, liquidated damages can be tied to critical milestone dates. However, the use of liquidated damages can be counterproductive if it causes the contractor to unnecessarily expedite work at the expense of quality of construction.

**IV. Risk transfer considerations**

A liquidated damages clause shifts the risk of project delay to the contractor and, in some instances, to the design professional. Such clauses are intended to fully compensate the client for anticipated damages in the event the project is delayed. However, the amount of damages should not be so high as to vastly exceed the actual damages suffered by the client. Clauses with unreasonable amounts may be unenforceable.

Liquidated damages clauses are appropriate risk-transfer devices for projects where the client can reasonably forecast, but not specifically measure, likely damages, especially if the project has been replicated several times before. Clients should anticipate the contractor’s request for a corresponding bonus provision to offset their added risk, although such bonus provisions are not required. If a bonus provision is included, the client should not be required to pay the contractor 100% of any savings it receives by early completion.

---

* Mr. Joe Basham practices primarily in the area of construction law and construction litigation. He frequently represents owners, general contractors, subcontractors, architects and engineers. Joe Basham joined the firm’s construction law practice as an Associate in 2002. Mr. Basham graduated from Texas A&M University, cum laude, in 1998, with a B.S. in Construction Science. While at Texas A&M, Mr. Basham was a charter member of Tau Sigma Delta, the international honor society for Architecture and the Allied Arts, and a member of Sigma Lambda Chi, the international honor society for Construction. Joe Basham graduated from Texas Tech School of Law Order of the Coif, magna cum laude, in 2002, where he was a member of the Texas Tech Law Review, and Technology Editor, 2001-2002.

---

**TRAVELERS**

travelers.com/1stchoice

Travelers Casualty and Surety Company of America and its property casualty affiliates. One Tower Square, Hartford, CT 06183

The views expressed in this article are those of the author and do not necessarily reflect the views of The Travelers Companies, Inc. or any of its subsidiary insurance companies (“Travelers”). This paper is for general informational purposes only. None of it constitutes legal advice, nor is it intended to create any attorney-client relationship between you and the author. You should not act or rely on this information concerning the meaning, interpretation, or effect of particular contractual language or the resolution of any particular demand, claim, or suit without seeking the advice of your own attorney.

© 2013 The Travelers Indemnity Company. All rights reserved. Travelers and the Travelers Umbrella logo are registered trademarks of the Travelers Indemnity Company in the U.S. and other countries. Ed. 11-13