

Strategies for Negotiating Liquidated Damage Clauses

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For those who negotiate construction contracts, we know some terms are much harder to negotiate than others (e.g., indemnity clauses, no damage for delay, warranties, assignment rights, etc.). Invariably, however, one of the toughest terms is the liquidated damage clause. In essence, the liquidated damage clause requires a contractor to pay a pre-determined amount of delay damages for failing to deliver the project timely. This article will briefly discuss the rationale for liquidated damages and then provide numerous options for reaching an agreement on this hotly disputed clause.

Liquidated damages are designed to protect the owner in the event the contractor delays completion of a project. These damages typically include extended carry costs (e.g., loans, insurance, etc.). However, these damages could also include lost rent and potentially lost tenants. For example, many leases have clauses that permit a reduction in rent or the complete cancellation of the lease if the premises are not delivered timely. In short, owners are exposed to significant damages for late delivery.

Sometimes the amount of actual damages suffered by the owner would be extremely difficult to establish. Indeed, the costs of calculating and proving these damages in court might rival the amount of the damages themselves. Accordingly, where damages would be difficult to ascertain, courts will typically allow the parties to reach an agreement on a fixed or “liquidated” damage amount. If the agreed upon amount is too high, courts might strike it (leaving the parties to prove actual damages) because “penalties” are typically not permitted in liquidated damage clauses; only reasonable estimates of actual damages.

Contractors typically loath liquidated damage clauses. However, in the absence of such a clause, the contractor is exposed to actual damages (as well as the costs of calculating and rebutting the owner’s assessment). Accordingly, it frequently makes sense for both parties to reach an agreement in advance on what those damages would be. The parties must not only agree on the amount of liquidated damages, but they must also agree on the form of the liquidated damage clause including what triggers payment. As noted below, the parties have numerous options.

What are the various options for liquidated damage clauses? First, the parties can agree payment of liquidated damages commences the day after the substantial completion deadline. Second, the parties can agree to give the contractor a grace period after substantial completion (e.g., liquidated damages commence on the seventh day after substantial completion, etc.). Third, the parties can agree the amount of liquidated damages will increase after time thresholds (e.g., \$500 for days 1-10, \$1,000 for days 11-21, etc.). Fourth, the parties can agree to put a “cap” on the amount of liquidated damages (e.g., in no event shall liquidated damages exceed the contractor’s anticipated profit as reflected in the agreed upon schedule of values).

Fifth, the parties can negotiate the liquidated damage and no damage for delay clauses together. In overly simplistic terms, a no damage for delay clause prohibits the contractor from seeking delay damages caused by the owner. Owner caused delays can arise if the owner fails to approve submittals timely or if the owner provides sub-standard architectural drawings. Under this fifth option, for example, the owner would permit the contractor to collect delay damages after a grace period and, in exchange, the contractor would permit the owner to collect liquidated damages after a grace period. Indeed, many liquidated damage clauses reflect such “horse trading”.

The question frequently asked is what is the “best” form of liquidated damage clause? The answer is contingent on numerous project-specific factors. For example, how familiar is the owner with the contractor, the contractor with the architect, and the contractor with the type of project?

Also, how does the contractor’s qualifications, bid amount, and availability compare with other contractors?

These factors often assist in determining which type of liquidated damage clause is “best” for a specific project.

In short, the liquidated damage clause is typically one of the most difficult clauses to negotiate. However, the numerous options should enable the parties to cobble together a mutually acceptable clause.

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