

LIQUIDATED DAMAGES DEMYSTIFIED

Kelly Gagliuso, Gagliuso & Gagliuso, PA

Commencement and substantial completion are two of the most important concepts covered in any construction contract. The time set for performance of your responsibilities is either measured from the contract's commencement date, or set forth as a specific date for completion of the project as a whole. Intertwined with these requirements you will often find some provision for the imposition of "liquidated damages" by the owner in the event that you fail to meet the completion dates specified in the contract. From a legal perspective, the amount of liquidated damages to be assessed should closely approximate the actual losses the owner or contractor will incur if the project is not finished on time. In practice, however, the damages assessed often bear little resemblance to such losses and are often more akin to a financial hammer used to induce timely performance.

Including a liquidated damages provision is optional in most standardized documents, including those published by AIA. In my experience, however, these provisions are used widely in both general and subcontracts to encourage compliance with time lines. There are well defined tests, developed by New Hampshire Courts, which can be applied to a liquidated damages clause to give you a sense of whether the clause will be enforceable on a given project. Being aware of these tests allows you to evaluate your risk of liability should your company be faced with delays or other circumstances which force your work to be performed beyond the milestone or completion dates required by the contract.

Test #1: Are the Potential Losses from a Delay Uncertain or Difficult to Calculate?

According to case law established in New Hampshire, inserting a liquidated damages clause in a contract is only appropriate under circumstances where the losses sustained by the owner or contractor in the event that completion dates are not met would be *uncertain* and *difficult to calculate*. In the case of new retail construction, for example, calculating the actual damages which could be sustained by the owner due to a delayed store opening would involve projecting the profits for a new store, with no recorded sales experience, during the period of the delay. Although not impossible, this would certainly be a difficult task. Therefore, including a liquidated damages provision in a retail construction contract will generally be considered appropriate.

Test #2: Did both Parties Intend to Liquidate Damages in Advance?

The contract must contain *clear evidence* that both parties intended to liquidate damages in advance

of beginning the work. The standard general and subcontract documents published by AIA contain a very clear and specific clause which allows a liquidated damages amount to be written in by the parties, or left blank if no liquidated damages are intended. In less formal contracts, these provisions are not so clear. For example, if the contract states that liquidated damages "may" be assessed for delays, but no amount is stated or agreed to by the parties, the court will not later allow the owner or contractor to impose an arbitrary amount which you did not agree to in advance. It must be clear that you made a conscious decision to liquidate damages in a specified amount.

Test #3: Is the Liquidated Damages Provision a Penalty Rather than Compensation?

The third prong of the liquidated damages test requires you to determine whether, at the time the contract was executed, the liquidated damages amount was a *reasonable approximation* of the losses which would be incurred in the event of a delay. Legally, a liquidated damages provision which bears no resemblance to the actual delay damages which the parties would have anticipated at contract signing will be deemed an unenforceable "penalty" and the provision will not be upheld. In making this determination, the court generally asks whether the liquidated damages figure is "greatly disproportionate to the presumable loss or injury" which would flow from the failure to achieve timely completion.ⁱ If the liquidated damages figure was not a reasonable estimate of likely damages, and is disproportionately large in comparison to the actual losses which could have been anticipated, it may not be enforced by the court.

Depending on the project, a liquidated damages clause which imposes a hefty daily or weekly penalty for delay may or may not be reasonable under the circumstances. In the case of a large retail firm, a large assessment may be perfectly justifiable due to the obvious magnitude of daily losses which can accumulate when sales cannot be made. Assume, however, that the project is one to expand a school building which is to be complete in late June, but did not finish until August. In this case, a large liquidated damages assessment might be out of line. There are no lost sales and, with children not returning to school until August, there may be no substantial cost to the School District associated with the delays.

In determining the reasonableness of the liquidated damages amount, however, the New Hampshire Supreme Court has ruled that it is appropriate to consider not only the *anticipated* loss at the time the contract was executed, but the *actual* losses eventually suffered by the owner or contractor as a result of the failure to meet deadlines. Even if the liquidated damages figure seemed reasonable at the time the contract was executed, if it turns out that no *actual* damages were incurred by the owner or contractor due to the delay, the liquidated damages provision will not be enforced and the aggrieved party will be awarded no more than its actual damages.

Conclusion: No Penalty!

In short, liquidated damages assessments *must* be a reasonable estimate of the actual damages which would be suffered by the owner or contractor in the event of delay or they will not be enforced. Should you find yourself up against a liquidated damages assessment which appears unreasonable under the circumstances, you should consult your attorney for advice on whether the provision can be invalidated because it fails to meet the tests set forth above. Better yet, evaluate the liquidated damages provision *before* signing the contract. If the damages to be assessed are excessive, consider whether you should negotiate a decrease or adjust the schedule to offset the risk. Generally, the liquidated damages amount is negotiable.

Fall 2005

i. *Shallowbrook Associates v. Dube*, 135 N.H. 40, 45 (1991)); see also, *Renaudette v. Barret Trucking Co.*, 167 Vt. 634, 635 (1988)

.