CCM Consulting Group

Volume 10, Number 2
October, 1997

News, Notes & Commentary

Liquidated Damages Uses and Limitations

Damages are awarded to one party in a contract upon breach of the other. Some contracts where time of performance is critical seek to stipulate the amount of damages due to either party due to non-performance. Clauses that stipulate damages to be paid are called liquidated damage clauses. Liquidated damage clauses containing damages substantially higher than actual losses are interpreted as penalty clauses and not enforceable.

Courts generally list three criteria by which a valid liquidated damages clause, can be distinguished from a penalty clause: (1) the damages caused by the breach must be difficult or impossible to estimate; (2) the parties must intend to provide for damages rather than for a Penalty; and, (3) the damages stipulated must be a reasonable pre-estimate of the actual damages.

Construction contracts commonly have liquidated damage provisions. Damages due to delay in a contract to construct a commercial building are sometimes not easy to estimate, satisfying criteria number one above, however a reasonable pre-estimate of actual damages can also be a difficult task.

Consider the following case as it relates to liquidated damages.

> Hospital X entered into a construction contract with contractor Y to construct a 220 bed, $75 million hospital in Florida. The project was to begin April 1, 1989 and finish October 1, 1990 just in time for the winter "season". A competing hospital had planned a remodel and expansion of its own, however, this competitor was not going to be complete with its construction until September 1, 1991.
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> At the time of the contracting liquidated damages were agreed to at $2,000 per day for every day after October 1, 1990 that the hospital was not approved for occupancy.
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> Within a few months after construction had begun, schedule delays began. The contractor also began having serious disputes with subcontractors about schedule performance. By October 1, 1990, the contractor was anticipating completion of July 30, 1991.
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> The hospital hired an independent scheduling consultant to analyze the work progress and access if the new completion date of July 30, 1991 was achievable. In January of 1991 this review was complete and the facts indicated that the actual completion date could be sometime after January, 1991. Based on this analysis a recommendation was made to terminate the contractor for default.

At issue arc several key questions that speak to the validity of liquidated damages. The questions are: (1) was the liquidated sum agreed upon, the parties' best estimate of what damages would be 18 months in the future? (2) is it difficult or impossible to determine the actual damage to the hospital for delay? (3) is there a point where excessive delay could be considered abandonment of the project and that liquidated damages would no longer apply? (4) is there some excessive amount of delay that was not within the contemplation of the parties and therefore after such time liquidated damages would not apply? (5) if actual damages due to the delay can be shown to be substantially greater than the stipulated sum should recovery be limited to liquidated damages?

Was the liquidated sum of $2,000 per day the parties best estimate of what damages would be, 18 months in the future? Interest cost on an investment of S75 million is predictable. At a rate of 8% simple interest the actual cost for a day of delay would be $16,438. Lost profits would also be an actual cost for delay. Loss of credibility with

the users of the hospital could also be anticipated as damages.

One could reasonably estimate that the actual cost of delay would he substantially in excess of $2,000 per day. However, too little liquidated damages may be interpreted as an allocation of risk. Therefore, the risk of performance normally assumed by a contractor has been reduced by the lower than actual liquidated damages.

Is there a point where excessive delay could be considered abandonment of the project and that liquidated damages would no longer apply? If prolonged delay occurs, the court may characterize it as equivalent to an abandonment of the contract.

The hospital was originally scheduled for completion in 18 months. Based on information given by the scheduling consultant a delay of 16 months was possible. Certainly this delay could be categorized as prolonged, in fact, it might be shown that contractor Y elected to delay the project and pay $2,000 a day rather than enforce project performance by its subcontractors at a greater cost. The courts might find that the liquidated damage clause was practically an option clause. And that the contractor was merely exercising its option to delay the project and pay $2,000 per day.

Delays in construction projects are common. The larger, more complex, and more regulated the project, the greater the possibility of delay. In relative terms, a 220-bed hospital is large, complex, and regulated. Even said, a 16 mouth delay is excessive and very probably outside the contemplation of the parties, It was known that a competing hospital would be built but would not be ready until the following winter season. Hospital X would have already had one full year of operation and its market share would be firmly established going into its second winter season. It could be shown that the parties had intended the liquidated damaged clause to be enforceable, but only for a period an anticipatable delay.

As can be seen, liquidated damages have their uses, and in extreme conditions, their limitations. Due care in analysis must be taken by both contracting parties before liquidated amounts are stipulated. It is possibly prudent to state in the liquidated damage clause what events are reasonably contemplated and which risks are being allocated among the parties as to further clarify the scope and intent of a liquidated damages clause.

Lump Sum General conditions

We have many clients that prefer to bid/negotiate construction contracts with lump sum general condition costs and make direct construction costs a GMAX. As you are aware, any contracting strategy can have limitations. Some of the limitations of lump sum general condition contracts are as follows:

Lump sum general conditions may cause the contractor to save money in the short term by reducing staff at the expense of proper management. Lack of management may increase the direct cost and if savings or contingency is built in to the GMAX the Owner pays all of the increase in direct cost and gets no savings in the lump sum general conditions. Additionally, the Contractor may be reluctant to spend more, although necessary, general condition money to get more supervision or engineering support if it looks as if the general conditions budget is in jeopardy.

The contractor may attempt to shift general condition costs to the direct construction costs by requiring the subcontractors to pick up some of the general condition costs in their contracts. We have recently witnessed superintendents charged as labor foremen, dumpster and toilet rentals required of subcontractors, dust control billed as site work, subcontractor backcharges credited to the lump sum general conditions, and project manager bonuses charged as cost of work.

A detailed minimum scope of work that is expected in the general condition cost is essential. Contractor employee names, positions and length of time contemplated also provide the Owner a useful management tool.

Free!

As always, we will be glad to review any contract you may be considering. While not a substitute for review by your legal counsel, we are in a good position to spot potential problems due to our extensive exposure to the result of different contract clauses. Please call any member of the group for further information.