Point/Counter-Point: Liquidated Damages

For the third article in this series, I am going to ask you to shift your perspective from the contractor/subcontractor relationship to that of the owner/contractor. In recent months, certainly as work remains available but finding available labor, and especially skilled labor, remains a challenge for many contractors I have been asked to address the issue of time and liquidated damages frequently. Both owner and contractor clients have asked these questions. Of course, the concerns and considerations differ based on where the inquisitor stands, but the frequency of these discussion indicate that a point/counter-point discussion about liquidated damages would be appropriate for this column.

From an owner's perspective, liquidated damages provide a way to both calculate and enforce the contractor's obligation of timely completion. From the contractor's perspective, liquidated damages can be a manner of assessing risk of delay and penalties owed for untimely performance. This explanation is the most basic way to describe liquidated damages. However, it is inadequate and partly misleading so I will explain further and caution all readers from latching onto and using this definition without explanation in the future.

For an owner, certainly on the variety of civil or infrastructure projects that are being bid or performed in the industry today, this definition is too simple when one considers the legal requirements for crafting an enforceable liquidated damages clause. Liquidated damages are allowed under Texas law as a mechanism to contractually agree on an amount as damages to compensate an injured party due to another's breach of a contractual obligation. In construction, liquidated damages are almost always used in the context of an owner's damages for delay caused by a contractor's late delivery of a project.

In order for liquidated damages to be enforceable as delay damages under controlling Texas law, the owner must craft its liquidated damages clause in a way that it makes clear (1) that the amount selected as a liquidated damage is not a penalty, (2) that the amount is determined in a way that is intended to compensate the owner for actual damages that will likely be incurred as a result of the delays, and (3) that the amount of damages, it component parts, and its true amount, are inherently difficult to ascertain, thereby making it advantageous and reasonable to estimate the damage and include it as a liquidated amount.

The problem from a public owner's perspective, whether it is TxDOT or a local governmental entity is that on many road and highway projects, the delay damages are not significant in terms of monetary comparison. On the other end of the spectrum, on water and wastewater infrastructure projects such as plant modification, rehabilitation or construction, the damages due to delayed delivery can be very significant but also difficult to fully predict and account for in a liquidated damage analysis before the project has begun.

Consider that liquidated damages are intended to compensate and owner for delay. On a job that has minimal exposure to monetary losses for delay, the biggest problems an owner may face due to delay may be political and may only be associated with the inconvenience or residual consequences with the public for late delivery. Monetary damages may not be able to adequately address this damage.

At the other end of the spectrum, an owner who is losing revenue, incurring longer financial carry costs, or paying consultants and designers additional fees due to time may under-estimate the delay damages during procurement. In this scenario, the liquidated damages may actually fail to fully compensate the owner for delay. Once the owner has selected liquidated damages as its remedy, it must stick with that remedy, even to its own detriment.

In both of the above scenarios, the owner may find itself in a situation where liquidated damages, despite being time-tested and commonly accepted, do not adequately remedy the harm done by delay. In these situations, the owner may be better off forgoing liquidated damages in favor of alternate tools to enforce time and the ability to recovery actual delay damages in lieu of liquidating them at the outset.

For the counter-point on liquidated damages, contactors often look at liquidated damages in two manners. Clearly, the liquidated damage amount is one that the contractor can evaluate as the cost it will incur in the event of delayed delivery. The other viewpoint is that the liquidated damage amount represents the risk, in a clearly identifiable way, that the contractor must price into its bid for the risk associated with delay.

The first scenario presents an overly simplistic view. On a highway project, the amount of liquidated damages will almost always pale in comparison to the actual damages the contractor will suffer due to delay. The value of the contractor's general field conditions will likely eclipse the liquidated damage amount. Contractors must realize this when bidding the jobs and working through events that may give rise to delay. Looking at a delay as only a $xxx loss is inadequate from a project management standpoint when daily general conditions could be in the thousands of dollars.

Additionally, contractors often view a liquidated damage amount as a penalty for late delivery. Clearly the owner who drafts an enforceable liquidated damages clause would not admit that the amount is intended to be a penalty. Candidly, however, the owner's project management team may view the liquidated damage as just that—a penalty and a stick to carry to compel timely completion. This mindset fails when the "penalty" is not actually a penalty because the value is too low. To often, a liquidated damage set high enough to actually incentivize a contractor to perform more quickly will not be enforceable under the controlling legal parameters.

Perhaps, given these considerations, parties will reevaluate the effectiveness of liquidated damages and how the amounts selected ought to be addressed in the procurement phase of bidding and awarding projects.

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