

CONSTRUCTION AND THE LAW IN TEXAS

The Law of Liquidated Damages

In a past legal column for Texas Contractor, liquidated damages were discussed with a focus on the ways parties to prime and subcontracts view and utilize liquidated damages. That column discussed the considerations and negotiating strategies associated with liquidated damages clauses in contracts. This column is taking a slightly more legal perspective in the hopes that readers will be better informed when the liquidated damages clauses and delays are an issue. Specifically, the goal of this column is to provide a general basis of understanding concerning the enforceability of liquidated damages so that all parties to contracts can better evaluate the risks associated with crafting, agreeing to, and challenging liquidated damages.

In the construction context, liquidated damages clauses are typically used as a mechanism to compensate the owner for delays and lost time due to the untimely delivery of a project. Similarly, contractors typically pass on the exposure to liquidated damages to their subcontractors. As a general rule, parties in Texas are free to contract as they see fit and courts will typically enforce contractual provisions as written. But there are circumstances where the law does not allow enforcement as written, even if the parties agreed in a fair and open negotiation.

Generally, in the delay context of construction contracts, liquidated damages provisions will be enforceable if the liquidated damages clause passes two tests: (1) the damages and harm that may be caused by the delay is either incapable or

difficult to estimate at the time the parties enter into the contract, and (2) the amount of liquidated damages called for is a reasonable forecast of the fair and expected compensation due to the delay. In layman's terms, this means that owners may use liquidated damages if the delay damages are difficult to predict at the outset of the project and the dollar value of the liquidated damages is a reasonable estimate of the damages due to exposure to delay. Under the law, owners have a legal obligation to predict with some accuracy the types and approximate amounts of damages that it might suffer if a delay occurs and not charge more than that prediction.

If an owner chooses to include a liquidated damages clause in its contract, there should be a front-end determination of the categories of delay damages that it might incur and the approximate amounts of exposure to each projected category. That projection should then be memorialized in the contract in the amount of the liquidated damages. Typically, construction contracts assess liquidated damages for delay as a per diem dollar value. However, liquidated damages do not need to be imposed as a per diem allocation. Owners are free to craft, and contractors are free to negotiate, liquidated damages provisions based on weekly or monthly values, or even a lump sum that might be triggered due to delayed performance. Of course, following the two-prong test above would require any lump sum to be tied to an expected damage that should be inherently difficult to ascertain with any certainty at

the time the contract is executed.

One key test that an owner must pass in seeking to enforce a liquidated damages provision is that the purpose and intent behind the clause cannot be a penalty. If the clause is intended to penalize the contractor for late performance, then the clause will not be enforced under Texas law. Contractors can challenge the imposition of liquidated damages based on its defense that the amounts are intended to be a penalty. For example, if the contractor believes and can show that the actual damages pale in comparison to the amount of liquidated damage, then the courts may not enforce the clause. Knowing this information may help the contractor in the initial negotiation and acceptance of the clause as well as in evaluating the risks associated with a potential dispute.

In order for a contractor to successfully challenge the imposition of a liquidated damages provision, an attempt should be made to show the actual delay damages claimed by the owner are disproportionate to the amount of actual damages incurred. A contractor challenging liquidated damages should be prepared to establish that the owner's actual damages for delay are significantly less than the liquidated damage or prove that the owner's motivation in drafting the clause was to penalize the contractor for late performance.

Understanding these legal standards governing liquidated damages should help both parties to a contract when drafting and negotiating contracts. A contractor who sees a proposed contract with a liquidated damages provision should consider the possible financial costs of delay and evaluate whether the dollar value accurately represents the anticipated damages. If that evaluation leads to the conclusion that the clause is operating as a penalty, the contractor may be able to proceed with a bid and a contract knowing that it may be able to challenge any future imposition of liquidated damages. However, this strategy does have some risks. If a clause is shown to be unenforceable, the court may allow the owner to establish its actual damages for delay. At times, those may exceed the liquidated damages that the contractor would have been exposed to for the project.

For example, some owners are currently moving away from the use of liquidated damages because there is a belief that the dollar values included in typical liquidated



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damages clauses often undercompensate for delay. Owners often fail to completely assess and identify all of the risks and cost that may be associated with delay. If the project at issue is one that has a revenue generation component for the owner when complete, the liquidated damages provision may account for the potential of lost revenue but fail to include costs for additional services from the design professional, attorney's fees, ancillary costs for financing, storage of materials, idle workforce, and the like. For all parties, understanding the legal and factual basis for any liquidated damages provision can improve one's position at the bargaining table.

