

Time Is Money: Recovery of Liquidated Damages by the Owner

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Primarily the law of contracts governs the relationships between parties on a construction project. This is true whether a homeowner is building a garage or a sophisticated commercial developer is constructing a high-rise office building. Unfortunately, when parties contract to build a project, the originally contemplated and the actual time frame for construction sometimes will differ. And just as for the contractor, "time is money" for the construction owner. Thus, when a project is not completed within the agreed-upon time period, the owner will seek compensation for delay. This article analyzes the obstacles facing an owner seeking recovery of delay damages and how these obstacles might be avoided through the use of "liquidated damages" provisions.

The most significant component of a commercial owner's delay claim is typically its lost revenues. An owner wants its project completed by a date certain so that it can receive a return on its investment as soon as possible. Thus, if contractor delays cause an owner to lose sales from its store or rental income from tenants in its mall,¹ lost revenues are the damages the owner will seek. The rationale for the recovery of these damages never varies: time is money, and lost time equals lost money—in the form of lost profits, unrecouped fixed costs, and even unrecouped variable costs that the owner unavoidably incurs during the delay.

Another common delay damage is the extended or increased interest on the owner's construction loan or permanent financing. When a project runs late, the owner pays more to its lender. This may be because the owner's construction loan is extended at a higher rate than the owner's permanent financing or because of an escalation in interest

rates during the delay period. Calculating the owner's additional interest expense is a complicated task because the additional interest expense must be projected over the life of the loan and then discounted to its present value. In essence, the owner's financing arrangements must be modeled using an "as planned" versus "as built" analysis.²

In addition to lost profits, owner delay damages include:

- material or labor cost escalation for owner-furnished items;
- extended rental payments while the owner awaits occupancy of its new facility;
- storage costs for the owner's furnishings, fixtures, and equipment;
- "additional services" charges by the owner's design professionals;
- extended duration costs of the "owner's representative";
- unrecouped costs of the owner's idle workforce;
- additional "builder's risk" and other insurance premiums;
- additional utility costs at the site; and
- in the case of "multiprime" or "follow on" contractors, the owner's liability for the duration-related expenses of other project participants.³

While each of these types of damages, alone, may not seem significant, their cumulative effect can be ruinous in the case of extended project delays.

Impediments to Owner Recovery of Delay-Related Damages

Owners face several challenges when seeking to recover compensation for contractor-caused delay. In addition to establishing the contractor's breach and causation, an owner also must be able to quantify its damages with "reasonable certainty." To do so, an owner must establish that its damages are not "speculative," but rather are "capable of being ascertained by reference to some definite standard, such as market value, established experience, or direct inference from known circumstances."⁴ This "reasonable certainty" requirement is particularly difficult for the owner seeking to recover lost profits resulting from the delayed opening of a new business.⁵

A construction owner must also prove that its claimed damages were foreseeable. The foreseeability analysis of a construction owner's delay damages begins where traditional analyses of contract damages claims begin: with the determination of whether the damages sought are "direct" or "consequential." "Direct" or "general" damages are those that arise naturally or ordinarily from a breach of contract; they are damages that, in the ordinary course of human experience, can be expected to result from a breach.⁶ In contrast, "consequential" or "special" damages

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are those that arise from the intervention of "special circumstances" not ordinarily predictable. Thus, the distinction between direct and consequential damages is dependent on whether the damages would be foreseeable in the "ordinary course of events" or only because of some "special circumstances" of which the party in breach may not have been aware.⁷

The distinction between direct and consequential damages is significant. If damages are determined to be "direct," they are compensable without any additional evidentiary showing.⁸ In contrast, if damages are determined to be consequential, they are compensable only upon a showing that the contracting parties could reasonably have anticipated the special circumstances. Whether the damages are direct or consequential is a question of law. Whether special circumstances were within the contemplation of the parties at the time of contracting is a question of fact.

It would seem that a comprehensive list of direct and consequential delay damages in the construction context would have been developed by now. Unfortunately, however, deciding whether construction delay damages are direct or consequential has proven to be exceedingly difficult for parties and the courts alike. As one commentator has noted, when one of the various courts' definitions of direct and consequential damages is compared to lists of what have been considered to fall in each category, "it is hard to distinguish between the definitions of direct damages and the definitions of consequential damages."⁹

The Virginia Supreme Court's decision in *Roanoke Hospital Ass'n v. Doyle & Russell, Inc.* illustrates the difficulties in establishing a "bright line" test by which construction delay damages are to be categorized. There, after carefully defining the difference between direct and consequential damages, the court concluded that the additional interest incurred by an owner during the delay period was, in part, a direct damage and, in part, a consequential damage.¹⁰ Specifically, the *Roanoke Hospital* court held:

We agree with the owner and the trial court that the extended financing costs are direct damages. Customarily, construction contracts, particularly large contracts, require third-party financing. Ordinarily, delay in completion requires an extension of the term of construction financing. The interest costs incurred and the interest revenue lost during such an extended term are predictable results of the delay and are, therefore, compensable direct damages.¹¹

However, the *Roanoke Hospital* court did not apply the same reasoning with regard to increases in the owner's "incremental construction interest costs" and "incremental permanent interest costs." With regard to those damages, the court wrote:

Increases in interest rates are not caused by delays in completion of construction contracts. Rather, they are caused by [variable market factors]. . . . For that reason, increases in interest rates are "special circumstances," and damages resulting therefrom are consequential and not compensable unless such circumstances were within the contemplation of the parties.¹²

Some authors have suggested that the difficulty in determining whether damages are direct or consequential lies with the nature of the construction process itself. For exam-

ple, Bruner and O'Connor suggest that "foreseeability" might be viewed more broadly in modern construction contracts than in other commercial contracting relationships for several reasons, including:

- (1) the sophistication of the parties;
- (2) the detail with which construction contracts are prepared;
- (3) the flexibility built into construction contracts to make changes or to give definition to contract requirements during construction;
- (4) the frequent practice of giving contractual definition to the type and amount of damages awarded for certain breaches;
- (5) the recognized "hurly-burly" of the construction process; and
- (6) the common industry appreciation for the likely consequences of most breaches.¹³

Simply put, the "contemplation" of the parties to a construction contract is often much broader than that of other commercial entities. As a result, "owners and contractors now routinely recover damage elements that prior generations of jurists would have regarded as 'unforeseeable.'"¹⁴

Owner Recovery Through Liquidated Damages Provisions

Much of the difficulty and expense encountered in attempting to satisfy the "foreseeability" and "reasonable certainty" requirements may be avoided through the use of "liquidated damages" provisions. Liquidated damages are "[a]n amount contractually stipulated as a reasonable estimation of actual damages to be recovered by one party if the other party breaches." They are typically expressed in terms of a "per diem" rate to be applied for each day of project delay, although the use of "stepped" or "escalating" per diem amounts also has been recognized.¹⁵

Liquidated damages have long been utilized in construction contracts, and their benefits are well documented. These benefits include the ease in allocating damages associated with construction disputes, the creation of firm expectations for all parties involved about what damages for delay will be, the avoidance of significant proof issues associated with establishing and quantifying a delay claim, and the potential savings of attorneys' fees, expert fees, and other costs incident to "proving up" an owner's delay damages.

The Evolution of Judicial Acceptance of Liquidated Damages Provisions

While early courts often hesitated to enforce liquidated damages provisions, most now enforce such clauses subject to certain qualifications. A case decided nearly 100 years ago expressed the "modern" view courts hold regarding liquidated damages:

The courts at one time seemed to be quite strong in their views and would scarcely admit that there ever was a valid contract providing for liquidated damages. Their tendency was to construe the language as a penalty, so that nothing but the actual damages sustained by the party aggrieved could be recovered. Subsequently the courts became more tolerant of such provisions, and have now become strongly inclined to allow parties to make their own contracts, and to carry out their intentions, even when it would result in the recovery of an amount stated as liquidated damages, upon proof of the violation of the contract, and without proof of the damages actually sustained.¹⁶

A more recent Illinois court summarized the modernizing trend in another way:

[L]iquidated damages provisions have been recognized more recently as appropriate in circumstances where the complexity of contractual relationships make[s] damages difficult to determine, since reasonably related, agreed upon liquidated damage amounts are easy to apply in such situations and satisfy the needs of the parties.¹⁷

The decision of whether to enforce a liquidated damages provision is generally a question of law for the court.¹⁸ In making this decision, courts typically apply some form of the following standard set forth in section 356 of the *Restatement (Second) of Contracts* in assessing the enforceability of liquidated damages provisions contained in construction contracts:

Damages for breach by either party may be liquidated in the agreement but only at an amount that is reasonable in the light of the anticipated or actual loss caused by the breach and the difficulties of proof of loss. A term fixing unreasonably large liquidated damages is unenforceable on grounds of public policy as a penalty.¹⁹

Many courts have expanded the *Restatement* language and the comments thereto into a three-part test for analyzing the enforceability of liquidated damages. One writer summarizes this test as follows:

While there is no universally applicable test for the enforceability of liquidated damages provisions, the *Restatement* test is generally applicable. Under the *Restatement*, courts look to three factors when determining whether to enforce a liquidated damages provision. First, the liquidated damages must be a reasonable estimation of the anticipated or actual damages that would result from a breach. Second, the actual damages that would result from a breach must be difficult to prove. Third, the provision must be intended to compensate for damages actually sustained, rather than to penalize the breaching party.²⁰

Most courts now take a deferential stance toward liquidated damages clauses when asked to review them in subsequent litigation over delayed construction projects. Even states that traditionally looked upon liquidated damages clauses with disfavor seem to be changing their approach. A notable example of this comes from Montana, a state that initially took a very negative view of liquidated damages.

The traditional Montana rule was established in *Story v. City of Bozeman*,²¹ a case interpreting Montana's liquidated damages statute. That statute reads as follows:

(1) Every contract by which the amount of damage to be paid or other compensation to be made for a breach of an obligation is determined in anticipation thereof is to that extent void, except as expressly provided in subsection (2)

(2) The parties to a contract may agree therein upon an amount which shall be presumed to be an amount of damage sustained by a breach thereof when, from the nature of the case, it would be impracticable or extremely difficult to fix the actual damage.²²

In *Story*, the City of Bozeman sought to recover liquidated damages for delayed construction of two water main construction projects. The *Story* court found that according to Montana law, liquidated damages clauses are generally prima facie void.²³ The court further found that to come within the exception to the rule, a party must show facts proving that "the damages would be extremely difficult or impracticable to ascertain and that the damages assessed are reasonably proportionate to

the actual damages sustained at the time of the breach." Finally, the court found that the party seeking to recover the liquidated damages has the burden of proving the above factors. Predictably, the court found that the city did not meet its burden and refused to enforce the liquidated damages clause contained in the contract.

More recently, however, Montana's hard-line rule with regard to liquidated damages has been softened—bringing that state closer to the modern "hands-off" trend adopted by the majority of jurisdictions. In *Arrowhead School District No. 75 v. Klyap*,²⁴ the Montana Supreme Court (in a case not involving construction law) expressly overruled its holding in *Story*, in the hope that courts will focus "on the fairness of the bargaining process" and less often "be drawn into an 'after the fact' debate."²⁵ The court held that "under the rule we adopt today, liquidated damages clauses are presumed enforceable. Further, the party seeking to avoid the clause has the burden of proving the clause is unconscionable."²⁶

This fundamental change in Montana law is illustrative of the general trend nationwide with respect to liquidated damages clauses.²⁷ Courts are much more likely to allow the parties to address their damages ahead of time and are much less inclined to judicially intervene unless such clauses are facially unreasonable.

The Spectrum of Judicial Deference Towards Liquidated Damages Provisions

The "Prospective Approach"

By definition, liquidated damages are artificial damages agreed to at the time of contracting as a substitute for actual damages.²⁸ Logically, then, liquidated damages clauses should be enforceable regardless of the amount of actual damages the owner sustains because of contractor-caused delays. This forward-looking standard of "prospective reasonableness" has been adopted by many jurisdictions throughout the country. Under this approach, the court's inquiry is limited to whether the sum agreed upon by the parties at the time of the execution of the contract represents a reasonable estimate of the actual damages that the party would sustain in the event of a delay.²⁹ Such an approach gives deference to the contracting parties "who negotiated a liquidated damage amount that was fair to each side based on their unique concerns and circumstances surrounding the agreement and their individual estimate of damages in the event of a breach."³⁰ Moreover, such an approach makes it unnecessary for the owner to expend time and money proving up the actual damages it suffered as a result of the delay.

An often-cited example of this prospective approach is found in *Southwest Engineering Co. v. United States*.³¹ There, the Eighth Circuit Court of Appeals found that the fact the party seeking the liquidated damages suffered no actual damages did not preclude an award of liquidated damages. As the *Southwest* court wrote:

Where parties have by their contract agreed upon a liquidated

damage provision as a reasonable forecast of just compensation for breach of contract and damages are difficult to estimate accurately, such provision should be enforced. If in the course of subsequent developments, damages prove to be greater than those stipulated, the party entitled to damages is bound by the liquidated damage agreement. It is not unfair to hold the contractor performing the work to such agreement if by reason of later developments damages prove to be less or nonexistent. Each party by entering into such contractual provision took a calculated risk and is bound by reasonable contractual provisions pertaining to liquidated damages.³²

The "Retrospective Approach"

On the opposite end of the spectrum, some courts will take a "second look" at the liquidated damages clause against the benchmark of the owner's actual damages.³³ In these courts' opinions, such a "retrospective" approach is necessary to ensure that the liquidated damages clause was neither arbitrarily chosen nor intended as a penalty.³⁴ This approach also allows courts to reject liquidated damages provisions that were the product of unequal bargaining power or that would produce a windfall profit for the owner.

Some courts go even further in their scrutiny of liquidated damages clauses, by analyzing the clauses in relation to the value of the underlying contract.³⁵ Other courts have expressly rejected this approach. In *Taos Constr. Co., Inc. v. Pensel Constr. Co., Inc.*,³⁶ for example, the Missouri Court of Appeals found that despite the fact the liquidated damages assessed equaled 66 percent of the value of the subcontract against which they were assessed, the liquidated damages clause nevertheless was enforceable. In addressing the argument that liquidated damages constituting such a large percentage of the contract value should be voided as a penalty, the court found that "any 'disproportion' must be measured against the amount of the harm, not the dollar amount of the subcontract."³⁷

Legislative Treatment of Liquidated Damages Provisions

In addition to Montana, some states have adopted statutes governing the enforceability of liquidated damages clauses. An often-cited statute is the California statute, in which that state expresses its view of the potential foreseeability of liquidated damages clauses as follows:

[A] provision in a contract liquidating the damages for the breach of the contract is valid unless the party seeking to invalidate the provision establishes that the provision was unreasonable under the circumstances existing at the time the contract was made.³⁸

The threshold for enforceability according to this statute is one of "prospective reasonableness": Is the liquidated damages provision reasonable in light of the owner's anticipated delay-related damages?³⁹

In addition to Montana and California, other states likewise address liquidated damages clauses in their statutory schemes, either directly or indirectly.⁴⁰ Most of these statutes allow parties to contractually agree to liquidate the damages recoverable in the event of nonperformance but provide no real guidance as to the acceptable parameters of these clauses.

Liquidated Damages as a Limitation on an Owner's Recovery

Owners must remember that liquidated damages are intended to accomplish just what the name implies: a "fixing" of damages at a certain level, generally expressed as a per diem amount. As such, liquidated damages become both a ceiling as well as a floor for establishing an owner's recovery for contractor-caused delay. Thus, an owner will rue the day when it agrees to liquidate its damages at an amount insufficient to adequately compensate it for the damages that it will suffer in the event of a project delay.

For example, in *Worthington Corp. v. Consolidated Aluminum Corp.*,⁴¹ the Fifth Circuit Court of Appeals enforced a liquidated damages clause as written and denied an owner a much larger potential recovery for actual delay damages. There, the court found that a counterclaim for \$4 million was properly subject to summary judgment due to the presence of a liquidated damages provision fixing the liquidated damages that the owner could recover from the contractor at \$500 per day with a maximum cap of \$100,000. The court held that "although [the owner] advances several creative arguments attacking this conclusion, we find them all insufficient to abrogate the unambiguous liability limitation in the contract."⁴²

Similarly, in *Brower Co. v. Garrison*,⁴³ the Washington Court of Appeals rejected an owner's efforts to recover actual damages in excess of those dictated by the parties' liquidated damages provision. Rejecting the owner's claims, the *Brower* court noted:

[The owner] drafted the contract and stood to benefit through [the liquidated damages provision]. It, alone, was in the best position to estimate the potential harm to be caused by delay and the actual compensatory damages needed to nullify that harm.⁴⁴

The distinction between direct and consequential damages is significant.

The Use of Liquidated Damages to Remedy Post-occupancy Delays

In most contracts, the parties agree that liquidated damages will be assessed only up to the date on which the contractor achieves substantial completion since, by definition, this date marks the time when an owner can enjoy beneficial occupancy of the project. Nevertheless, it also is possible to "liquidate" the damages an owner will suffer during the time period from substantial to final completion. Indeed, the standard form construction agreements sponsored by the Construction Owners Association of America (COAA) and the Engineer's Joint Contract Documents Committee (EJCDC) provide for the liquidating of damages during this period.⁴⁵

Generally speaking, these types of liquidated damages provisions attempt to account for the damages an owner

will sustain after taking occupancy of the project and while the contractor is completing its punch list work on the project. The damages suffered by an owner during this time period are generally thought to be less significant in nature than those an owner would suffer in the event of a delayed substantial completion. As such, parties will generally agree to liquidate an owner's postsubstantial completion delay damages at amounts less than the liquidated damages amount claimed through substantial completion. As with the substantial completion liquidated damages provisions, there is no hard-and-fast rule as to the enforceability of these provisions. However, the COAA form agreement offers guidance as to the amount of these final completion liquidated damages by providing as follows:

If the Builder has failed to achieve Final Completion by the required date of Final Completion as established as previously set forth in this Contract For Construction, the Builder shall pay to the Owner, as liquidated damages for delay and not as a penalty, fifteen (15%) percent of the daily amount stated for failure to timely achieve Substantial Completion, even if not actually imposed, for each calendar day of unexecuted delay in achieving Final Completion.⁴⁶

Arbitration has led to a lack of appellate case law interpreting these provisions.

Incentive/Disincentive Clauses

One type of liquidating provision that has found increasing favor in the courts is a clause that not only assesses per diem damages against a contractor for slower-than-contracted performance, but also rewards contractors for faster-than-anticipated performance. Such "early completion" bonuses can be particularly useful in situations where the owner stands to enjoy significantly enhanced financial gain from an accelerated construction schedule. Furthermore, if the owner can develop an incentive/disincentive clause that properly reflects the premium it places on early completion and properly incentivizes the contractor to complete work ahead of schedule, potential profits can be realized for both the owner and contractor alike. From an enforceability standpoint, when a reward component is offered in the contract language to offset the potential damages clause for delayed performance, the damages provision may look much less like an unenforceable penalty in the eyes of a court.

Apportionment of Responsibility for Liquidated Damages

Another question often arising with regard to liquidated damages is whether they may be apportioned when the fault underlying the delay lies with multiple parties. The traditional rule was if an owner contributed even in part to the delays, the owner was prohibited from recovering any liqui-

dated damages from the contractor.⁴⁷ In recent years, however, this traditional rule has begun to change. Courts increasingly attempt to apportion responsibility for construction delays such that liquidated damages can be likewise apportioned.⁴⁸ In *Aetna Casualty and Surety Co. v. Butte-Meade Sanitary Water District*,⁴⁹ the U.S. District Court for South Dakota established what is regarded as the modern rule in its holding:

The evidence in this case clearly establishes that the [bonding company], [owner] and the contractor were all at least in part responsible for delaying the completion of this project. Apportioning the delay among these parties has proved to be quite difficult. However, this Court feels that recent case law is clearly in favor of such apportionment of fault and that simply because [the owner] contributed to the delay in completion of the project, it should not be barred from recovering liquidated damages.⁵⁰

Similarly, in *Calumet Construction*, the Appellate Court of Illinois found that:

The older rule of non-apportionment is now being abandoned by a growing number of courts in favor of the more modern rule of apportionment because of the increasing popularity of liquidated damages clauses, in part, due to the increasing complexity of contractual relationships, and, in part due to the fact that the older rule is too harsh in its application.⁵¹

Later in its opinion, the court summarized its reasoning for adopting the "modern rule," ruling for apportionment:

If this court were to adopt the harsh rule of non-apportionment, the end result would be that liquidated damages clauses would never be enforceable in the large, complex construction contracts for which they were intended, since, as stated, there will always be some unintentional delay attributable to the owner.⁵²

The *Calumet* court concluded that the modern rule would have a better long-term application to construction projects and their accompanying agreements. In so holding, the *Calumet* court rejected the argument that the complexities of modern construction disputes make it too difficult for a trial court to "sort through" evidence as to whom the delays were attributable. To the contrary, said the *Calumet* court, sorting through such evidence and making determinations about apportioning delay would be no more difficult than apportioning fault in a comparative negligence case.⁵³

Agreements to Liquidate Only a Portion of an Owner's Delay Damages

Some decisions have held that a liquidated damages clause limited to specified kinds of delay damages will not preclude recovery of additional delay damages under other contractual provisions or under other theories of recovery.⁵⁴ On this point, the U.S. Supreme Court once reasoned that "[t]here is no reason why parties competent to contract may not agree that certain elements of damage difficult to estimate shall be covered by a provision for liquidated damages and that other elements shall be ascertained in the usual manner."⁵⁵ Thus, an owner apparently can liquidate certain types of consequential damages that are difficult to ascertain, but also contract for the recovery of other sorts of actual damages. In this way, an owner might "have his cake and eat it too" on delay damage recovery.⁵⁶

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(Gregg Bundschuh and David Collings of Marsh USA) have a talent for being able to explain clearly even the most convoluted of insurance concepts. One way they do this is by liberally using hypothetical situations to get across their points. This chapter will not make you an insurance expert, but it will give you some critical tools to help you understand nuances behind insuring a design/build project.

Chapter 5 discusses design/build procurement at the federal level. Although this is the shortest of all the chapters (only seven pages), it does provide the basics of the federal two-phase design/build process. Readers who need to know more about the myriad issues associated with federal procurement (negotiation, protests, and other issues) will need to consult a different treatise for help.

As with any multiple-jurisdiction, survey-based treatise, new editions are typically published to deal with the need to update information. In the fast-paced world of licensing and procurement for design/build projects, this is especially critical. Changes are happening all over the country, and it is often hard to keep pace in your own state, let alone other states where your clients have projects. These updates make this third edition worth purchasing.

There is one other new feature of this edition that I liked and that I think provides great value. The editors spend sig-


nificant time covering design/build in the highway and transportation arena, a hot topic for many in the industry that was not covered in the previous editions of the book. The introduction has an informative discussion on TEA-21 and the Federal Highway Administration's regulations, as well as a detailed discussion of the North Carolina Department of Transportation's design/build procurement approach. Readers also should note that the eighth survey question and map (the use of design/build in highway and transportation projects) was not covered in previous editions of this book. The question is answered for each state and province, and, in my view, this is an incredibly helpful resource.

While the topics covered by this book are covered by other treatises in my design/build library, I have found myself typically using this book as an initial "go-to" source for state licensing or procurement questions. It is readable, well organized, and fairly complete. Most important, my experience has been that the contents are generally accurate—always a challenge with a fifty-state survey book. I commend John Heisse and Jim Schenck for their diligence in keeping up with the formidable task of updating this resource, and I thank them for making my life easier. 

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(and custom-drafted) contracts. She dissects several drafting issues, not the least of which is "pay-when-paid." For lawyers seeking to enforce (or drafting to avoid) such conditions, this payment provisions article represents a sure road map.

Still another approach to payment appears in Harper Heckman and Benjamin Edwards' examination of liquidated damages. The authors discuss impediments to recovering delay-related damages, and then review how judges have come to recognize and enforce liquidated damages provisions. They properly warn against an unthinking reliance on liquidated damages, and they also navigate the reader through various drafting possibilities.

Finally, our new Chair, Jim O'Connor, reflects on the founders of The Forum as we approach our thirtieth anniversary. He captures their enthusiasm and lasting contributions to the organization, which should inspire the reader to similar efforts. Get involved: write an article for *The Construction Lawyer*, come to a program, or become active in one of The Forum's dozen sections. Because you have our e-mail addresses, you can let us know what you like, dislike, or want *The Construction Lawyer* to be. Or, at the very least, tell someone else about The Forum and see to it that he or she becomes an active member. 

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Negotiating and Drafting an Enforceable Liquidated Damages Provision

Given the *Restatement's* prohibition of liquidated damages clauses that act as a penalty, many drafters include "self-serving" language in their liquidated damages provisions to announce to the world that the clause is to be construed "not as a penalty," but rather as a "reasonable estimate of the owner's delay damages." Despite these efforts, however, courts will look beyond the label applied in the contract documents and to the reasonableness of the clause itself.⁵⁷ Indeed, some courts have even enforced liquidated damages provisions that were expressly labeled as a penalty.⁵⁸

Simply put, when defending the validity of a liquidated damages provision, a party's actions will speak louder than its words. Accordingly, an owner would be prudent to document both its efforts to estimate the actual damages it would likely sustain in the event of a project delay and its negotiation with the contractor as to the amount of the liquidated damages to be accepted as substitution for those actual damages. Otherwise, the owner may be unable to satisfy a reviewing arbitrator or court as to the reasonableness of its liquidated damages. In *S O G v. Missouri Pac. R. Co.*,⁵⁹ for example, the Eighth Circuit Court of Appeals rejected a liquidated damages provision because it did not reflect "a bona fide attempt by both contracting parties to agree in advance on a reasonable forecast of just compensation for any harm which would be caused by delayed per-

formance on the part of [the contractor]" and because the contractor did not participate in estimating the per diem amounts set forth in that provision.

Finally, an owner would be wise to carefully document the actual delay damages that it experiences on a project in case those damages are needed to support the enforceability of the liquidated damages provision.⁶⁰ Moreover, if the liquidated damages clause ultimately proved to be unenforceable, an owner could still prove and recover its actual damages.⁶¹

The Treatment of Liquidated Damages Provisions in Industry Form Agreements

Recently, industry groups have begun dealing specifically with the recovery of consequential damages in their form contract documents. Because the treatment given to consequential damages by these form contracts may impact the owner's recovery of liquidated damages, some discussion of these form agreements is appropriate.

Groups such as the AIA,⁶² the AGC,⁶³ and the DBIA⁶⁴ have included a specific waiver of consequential damages (including consequential delay damages) in their form contracts. The Standard Forms of Agreement recently published by the AOD⁶⁵ also includes a waiver of consequential damages.⁶⁶ Utilizing a unique "menu" approach, the AOD form agreements give an owner the alternative of allowing recovery of mutual damages by both owner and contractor, requiring only the contractor to waive its consequential damages, or providing for a mutual waiver of consequential damages by both the owner and contractor.

In contrast, the EJCDC⁶⁷ has elected not to include any mutual waiver of consequential damages in its form contract documents, and the COAA,⁶⁸ in its form agreements, requires only the contractor to relinquish its right to recover indirect or consequential damages.⁶⁹ Thus, under the EJCDC and COAA form agreements, an owner is permitted to recover all delay damages, both consequential and direct, that it is entitled to recover under applicable law.

Those form agreements that provide for the waiver of an owner's consequential damages also provide an extensive, nonexclusive categorical listing of specific types of consequential damages waived. Despite a rather exhaustive detailing of consequential damages subject to the waiver, none of these form agreements specifies the "direct" damages that an owner is entitled to recover from the contractor in the event of project delays for which the contractor is responsible. This ambiguity is further compounded by the fact that most of these form agreements mandate that the parties resolve any disputes among themselves through arbitration. This has led to a lack of appellate case law interpreting these provisions. As such, the mutual waiver of consequential damages has been the source of much confusion, conjecture, and debate since these provisions first appeared in the mid-1990s.

Of particular interest in the interplay between the mutual waiver and any liquidated damages provisions provided in the contract are the AGC and AIA agreements, which deal with liquidated damages in a similar fashion. The AGC

agreement provides that its mutual waiver of consequential damages "shall not be construed to preclude contractual provisions for liquidated damages when such provisions relate to direct damages only."⁷⁰ The AIA also allows an owner to liquidate only its direct damages by providing that nothing contained in its mutual waiver shall be deemed to preclude an award of "liquidated direct damages when applicable, in accordance with the requirements of the contract documents."⁷¹

In contrast to the AGC and AIA, the DBIA form agreements allow owners significantly more flexibility in the recovery of liquidated damages. Its contracts provide that:


[T]he consequential damages limitation is not intended to affect the payment of liquidated damages, if any, which both parties recognize have been established, in part, to reimburse owner for some damages that might otherwise be deemed to be consequential.⁷²

Similarly, the AOD agreement provides that:

Nothing [in the mutual waiver] is intended to prevent, limit, or effect the enforcement of any provision in the Contract Documents for the payment of liquidated damages, including any portion or component of liquidated damages that are or may be special, indirect, or consequential.⁷³

Accordingly, while the AGC and AIA agreements purport to limit liquidated damages to only direct damages, the DBIA and AOD agreements allow for the liquidation of all damages, both direct and consequential.

For parties utilizing liquidated damages clauses in form agreements such as those sponsored by the AGC and AIA, an interesting issue arises as to how the enforceability of that liquidated damages provision is to be analyzed. Given the express prohibition in these form agreements against the recovery of consequential damages, the liquidated damages provision apparently should be evaluated only with reference to an owner's actual or potential direct damages. Thus, liquidated damages provisions that might seem reasonable in relation to an owner's consequential damages nevertheless might be viewed as penal when analyzed with reference to only the owner's direct damages.

The uncertainty surrounding the concept of "liquidated direct damages" suggests that owners would be prudent to strike the references in the AIA and AGC agreements to the liquidation of an owner's "direct" damages and, instead, add language similar to the DBIA and AOD agreements that allows the parties to liquidate the owner's direct and consequential damages. Careful owners also will wish to add language to the liquidated damages provision itself recognizing that the damages agreed upon are intended to liquidate direct and consequential damages alike.⁷⁴ 

Endnotes

1 *Miami Heart Inst. v. Heery Arch. & Eng'rs., Inc.*, 765 F. Supp. 1083 (S.D. Fla. 1991); see also *Camper v. WJ McDermott*, 266 Cal. App. 2d 41, 71 Cal. Rptr. 590 (Cal. App. 1968).

2 See John I. Karesh & James Marino, *Owner's Claims*, in *PROVING AND PRICING CONSTRUCTION CLAIMS* 12.35 (Cushman, Jacobsen, Trimble eds. 1996).

3 See *id.* at 13.11-13.16; WILLIAM SCHWARTZKOPF AND JOHN J. MCNAMARA, *CALCULATING CONSTRUCTION DAMAGES* § 12.04 (2d ed. 2001); Richard F. Smith, Scott D. Gray & W. Stephen Dale,

Delay Damages, in CONSTRUCTION BUSINESS HANDBOOK 470-74 (Cushman ed. 2004); PHILLIP L. BRUNER & PATRICK J. O'CONNOR, BRUNER & O'CONNOR ON CONSTRUCTION LAW § 19.63-19.68 (2002).

4. See Michael J. Cook, Richard F. Bero & Bret R. Gunnell, *Claims for Lost Profit*, in PROVING AND PRICING CONSTRUCTION CLAIMS 14.14 (Cushman, Jacobsen, Trimble eds., 1996).

5. See *id.* at 14.15-14.19 (citing cases and authorities); see also *McDevitt & Street Co. v. Marriot Corp.*, 713 F. Supp. 906 (E.D. Va. 1989), *aff'd in part*, 911 F.2d 723 (4th Cir. 1990); *A&P Bakery Equip. Co. v. Hawatmeh*, 388 So. 2d 1071 (Fla. Dist. Ct. App. 1980).

6. *Roanoke Hospital Ass'n v. Doyle & Russell, Inc.*, 214 S.E.2d 155 (Va. 1975).

7. THE RESTATEMENT (SECOND) OF CONTRACTS § 351 provides this guidance:

(1) Damages are not recoverable for loss that the party in breach did not have reason to foresee as a probable result of the breach when the contract was made

(2) Loss may be foreseeable as a probable result of a breach because it follows from the breach

(a) in the ordinary course of events, or

(b) as a result of special circumstances, beyond the ordinary course of events, that the party in breach had reason to know

8. *Desco Corp. v. Trushel Constr. Co.*, 413 S.E.2d 85, 89 (W. Va. 1991).

9. Lynn R. Axelroth, *Mutual Waiver of Consequential Damages—The Owner's Perspective*, 18:1 CONSTR. LAW 11, 12 (Jan. 1998).

10. *Roanoke Hospital*, 214 S.E.2d at 161.

11. *Id.*

12. *Id.*

13. BRUNER & O'CONNOR, *supra* note 3, at § 19.18 (internal citations omitted).

14. *Id.*

15. *Grenier v. Compratt Constr. Co.*, 454 A.2d 1289 (Conn. 1983).

16. *United States v. Bethlehem Steel Co.*, 205 U.S. 105 (1907).

17. *Calumet Constr. Corp. v. Metro. Sanitary Dist. of Greater Chicago*, 533 N.E.2d 453, 456 (Ill. App. 1988).

18. Kyle E. Hart, *Liquidated Damages*, in CONSTRUCTION BUSINESS HANDBOOK 658 (Cushman ed. 2004).

19. RESTATEMENT (SECOND) OF CONTRACTS § 356.

20. Hart, *supra* note 18, at 650.

21. 856 P.2d 202 (Mont. 1993).

22. *Id.*

23. *Id.* at 228 (citing, *inter alia*, MONT. CODE ANN. § 28-2-721 (emphasis added)).

24. 79 P.3d 250 (Mont. 2003).

25. *Id.*

26. *Id.*

27. See BRUNER & O'CONNOR, *supra* note 3, at § 19.52 (explaining that the common law doctrine of "freedom to contract" has few traditional exceptions).

28. *Calumet Constr. Corp. v. Metro. Sanitary Dist. of Greater Chicago*, 533 N.E.2d 453, 455 (Ill. App. 1988).

29. SCHWARTZKOPF & MCNAMARA, *supra* note 3, at § 13.02, fn. 8.

30. *Kelly v. Marx*, 705 N.E.2d 1114 (Mass. 1999).

31. 341 F.2d 998 (8th Cir. 1965).

32. *Id.* at 1003; see also *Pub. Health Trust of Dade County v. Romart Constr. Inc.*, 577 So. 2d 636 (Fla. Dist. Ct. App. 1991) (holding that the trial court should have given effect to a liquidated damages clause assessing \$2,500 per day and finding that the fact the owner "may have suffered no monetary loss for this 68-day delay" did not affect the enforceability of the clause); *Appeal of Preston-Brady Co., Inc.*, V.A.B.C.A. No. 1892, 1987 WL 41248

(Mar. 3, 1987) (liquidated damages enforced despite fact that owner could not establish any actual damages).

33. See SCHWARTZKOPF & MCNAMARA, *supra* note 3, at § 13.02, fn. 5.

34. Hart, *supra* note 18, at Chapter 21.

35. *Ledbetter Brothers, Inc. v. NCDOT*, 314 S.E.2d 761 (N.C. App. 1984).

36. 750 S.W.2d 522 (Mo. App. 1988).

37. *Id.* at 527.

38. CAL. CIV. CODE § 1671(b) (West 1977).

39. *Ridgley v. Topa Thrift and Loan Assoc.*, 953 P.2d 484 (Cal. 4th 1998).

40. FLA. STAT. ANN. § 337.18 (West); GA. CODE ANN. § 13-6-7; LA. CIV. CODE ANN. Art. 2005 (West); WASH. REV. CODE ANN. § 4.24.360 (West).

41. 544 F.2d 227 (5th Cir. 1976).

42. *Id.* at 235; see also *Metro. Dade County v. Frank J. Rooney, Inc.*, 627 So. 2d 1248 (Fla. Dist. Ct. App. 1993) ("Liquidated damages are in lieu of actual delay damages and an owner cannot elect to seek actual delay damages simply because the actual damages are greater than the liquidated damages"); *Burns v. Hanover Ins. Co.*, 454 A.2d 325 (D.C. 1982) (finding that a contract clause that did not delineate to which potential damages it applied could serve to substitute for all actual damages and should be enforced as written).

43. 468 P.2d 469 (Wash. App. 1970).

44. *Id.* at 477.

45. See COAA, Contract for Construction—General Terms and Conditions, COAA Doc. No. B-300-GC/CM, ¶ 17.2 (2003); EJCDC, Standard Form of Agreement Between Owner and Contractor, EJCDC Doc. No. C-520, ¶ 4.03 (2002).

46. *Id.*

47. *L.A. Reynolds Co. v. State Highway Comm.*, 155 S.E.2d 473 (N.C. 1967); *United States v. United Eng'g & Constructing Co.*, 234 U.S. 236 (1914); *Caldwell & Drake v. Schmulbach*, 175 F.429 (N.D.W.V. 1909).

48. See *Southwest Eng'g Co. v. United States*, 341 F.2d 998 (8th Cir.), *cert. denied*, 382 U.S. 819 (1965).

49. 500 F. Supp. 193 (D.S.D. 1980).

50. *Id.* at 197.

51. 533 N.E.2d 453, 456.

52. *Id.* at 457; see also STEVEN G.M. STEIN, CONSTRUCTION LAW, § 6.10[3] (2003).

53. *Calumet Construction*, 533 N.E.2d at 457.

54. STEIN, *supra* note 52, at § 6.10[2] (citing, *inter alia*, *Northern Petrochemical Co. v. Thorsen & Thorshov, Inc.*, 297 Minn. 118, 211 N.W.2d 159 (1973)).

55. *Hathaway & Co. v. United States*, 249 U.S. 460 (1919).

56. See, e.g., *Hillsborough County Aviation Auth. v. Cone Brothers Contracting Co.*, 285 So. 2d 619 (Fla. Dist. Ct. App. 1973) (finding that "[i]n the interpretation of contracts, it must be assumed that each clause has some purpose." and holding that an owner could recover both under a liquidated damages provision and for other damages addressed by a separate contract clause).

57. See *S.O.G. Etc. v. Missouri Pac. R. Co.*, 658 F.2d 562 (8th Cir. 1981). For a discussion of the frustration that can accompany liquidated damages provisions due to uncertainty for the parties, see Scott M. Tyler, *No (Easy) Way Out: "Liquidating" Stipulated Damages for Contractor Delay in Public Construction Contracts*, 44 DUKE L.J. 357 (1994) (suggesting a uniform statutory scheme governing the "validity and enforceability for fixed delay damages that meet certain parameters in public construction contracts" as an effective solution).

58. See *Grenier v. Compratt*, 454 A.2d 1289 (Conn. 1983).

59. 658 F.2d at 562.

60. For a useful checklist to be referenced when negotiating and drafting liquidated damages provisions, see Hart, *supra* note 18, at 662-63, and SCHWARTZKOPF & MCNAMARA, *supra* note 3,

at 260-64

61 Kingston Constructors, E.N.G.C.B.A. No. 6006, 97-1 B.C.A. (CCH) ¶ 28,646.

62 The American Institute of Architects.

63 The Associated General Contractors of America.

64 The Design Build Institute of America

65 The Associated Owners and Developers

66 See AOD, Standard Form of Agreement Between Owner and Contractor for a Fixed or Lump Sum Price [hereinafter Standard Form 1], AOD Doc No. 2002, General Contract—Lump Sum, ¶ 8.6.1 (2002), and Standard Form of Agreement Between Owner and Contractor for Work on a Cost Plus Fee Basis with a Guaranteed Maximum Contract Price [hereinafter Standard Form 2], AOD Doc. No. 2002, General Contract—Guaranteed Maximum Price, ¶ 8.6.1 (2002)

67 The Engineer's Joint Contract Documents Committee

68 The Construction Owners Association of America, Inc

69 See COAA, *supra* note 45, ¶ 26.6.

70 See AGC, Standard Form of Agreement and General Conditions Between Owner and Contractor, AGC Doc. No. 200, ¶ 10.2.9 (1997).

71 See AIA, General Conditions of the Contract for Construction, AIA Doc. No. A201, ¶ 4.3.10 (1997)

72 See DBIA, Standard Form of General Conditions of Contract Between Owner and Design-Builder, DBIA Doc. No. 535, ¶ 10.5.2 (1998).

73 See AOD, *supra* note 66, Standard Form 1, ¶ 8.6.2, and Standard Form 2, ¶ 8.6.2.

74 The DBIA form agreement No. 525 has done just that by adding the following final sentence to its liquidated damages provision: "The liquidated damages provided herein shall be in lieu of all liability for any and all extra costs, losses, expenses, claims, penalties and any other damages, whether special or consequential, and of whatsoever nature incurred by Owner which are occasioned by any delay in achieving substantial completion."

PAYMENT PROVISIONS (Continued from page 39)

not the fault of the Subcontractor, then payment by Owner shall not be a condition precedent to payment of Subcontractor by Contractor

Use of this alternative contractually incorporates what some courts have called the "prevention doctrine."¹¹⁰ Under this principle, the contractor cannot defeat the claim of a subcontractor by relying upon a pay-if-paid clause where the contractor is at fault for nonpayment by the owner. The logic is that if the contractor has by its own fault lost the right to payment from the owner, the subcontractor is still entitled to compensation.

A potential problem with this alternative is that "fault" is often difficult to determine. In many disputes, the responsibility for a particular failure to pay does not rest solely with the contractor. Rather, responsibility rests with the contractor and one or more of its subcontractors. Allegations of schedule impact, project delay, and delays to other subcontractors may compound the contractor's ability to attribute the failure of performance to one particular subcontractor.

The practical application of this clause may require the trier of fact to sort through the alleged failure to perform of the contractor and its subcontractors, resulting in lengthy claims proceedings, which generally do not lend themselves to summary disposition. The cumulative result of all of this may be unnecessarily increasing costs associated with resolving pay disputes.

Some courts resolve this potential problem by finding that the subcontractor need not establish the condition would have occurred "but for" the wrongful conduct of the contractor, or even that the contractor actually prevented the condition.¹¹¹ Instead, the subcontractor need only prove that the conduct of the contractor materially contributed to the nonoccurrence of the condition. In this case, it is enough that the contractor merely hindered performance of the condition.¹¹²

It should be noted that the text of this alternative clause has wider use than simply addressing nonpayment that is not the subcontractor's fault. This clause can be customized to provide for the lifting of the condition precedent based

upon the occurrence of other identifiable events, such as owner bankruptcy or insolvency

Modify the Pay-If-Paid Clause to Terminate the Condition Precedent After a Finite Time

Any condition precedent for payment to Subcontractor based upon receipt of payment from Owner by Contractor shall extend only for a period of [e.g., 120] days after the date of Subcontractor's application for payment covering work properly performed and material suitably stored

It states that distinguish between the two, an obvious way to modify a pay-if-paid clause is to convert it to a pay-when-paid clause. This is accomplished by eliminating the condition precedent after a contractually stated period of time.

Conclusion

Each of the form contracts discussed herein provides a stepped payment process. Also, each of the forms also affords the owner protection of its capital investment in the project and the contractor and subcontractors protections of their labor and material investment in the project. Though there is some effort in these documents to provide fairness in the payment provisions, at times fairness succumbs to protecting the group represented by the authorship of the document. The alternatives proposed are intended to fill in gaps in the payment provisions and to provide more balance for the participants in the risky business of construction. ■

Endnotes

1 Portions of this article utilize ideas and, in some instances, text of chapters from *The Construction Contracts Book*, on which this author served as co-editor and contributing author. The book is being published by the ABA Forum on the Construction Industry and will be available in Fall 2004. The author wishes to acknowledge the contribution of William H. Hughes, Jr., of Alston & Bird LLP, who authored the original payment chapter for the book. The author also acknowledges the dedication and contribution of the co-editors of the book, Daniel Brennan of Piper Rudnick, John Spangler of Alston & Bird, and Rick Lowe of Jacoby Donner, as well as the guidance and direction of Ty Laurie.

2 Buckner Hinkle, Jr., *The Payment Process Under A201*, 16