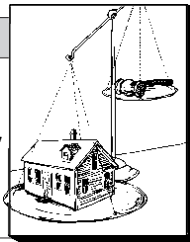


Liquidated Damages: a Double-Edged Sword

by Reina Calderon, Esq.



Owners negotiating contracts with general contractors frequently insist on a "liquidated damages" provision. This is a clause that provides for defaults in performance: The defaulter will pay the injured party a sum of money agreed upon by both parties in advance. Having a liquidated damages clause in the construction contract means that if the owner ever sues the contractor for failure to perform, the owner's job in court will be much easier. Theoretically, all that an injured party must do at this point is show that the defaulter failed to perform. He doesn't have to prove how much he suffered (the amount of damages) because the parties have agreed in advance what that sum will be.

Without a liquidated damages provision, proving damages can be tough, particularly since the owner has a duty to "mitigate," that is, lessen his damages. For instance, an owner trying to collect for relocation costs has to prove that those costs were both reasonable and unavoidable.

A liquidated-damages clause may be important to a contractor who is facing a project with a high risk of failure. Or suppose the owner is not someone the contractor fully trusts...

Fear of the Unknown

For the general contractor, the liquidated damages clause may look like a good thing. Rather than face the prospect of being sued in the future for an unknown and perhaps very high sum, it might be simpler, he thinks, to fill in the blank provided in the 1987 AIA Owner-Contractor Construction Contract (Form A111-1987, section 4.2), which states "Insert provisions, if any, for liquidated damages relating to failure to complete on time." This would put a cap on damages due to default, and the contractor would have one less worry. But it isn't always wise. Under what circumstances does it make sense to opt for this type of provision?

The answer depends on the relative bargaining power of the parties, as well as the sum being discussed. From the owner's point of view, how much is riding on the timely completion of the project? And what are the likely damages? From the general contractor's perspective, this is one instance where it pays to gauge his

potential opposition. How hard will the disappointed owner (once he is a plaintiff) fight to recover damages? Is the amount of the damages proposed as the liquidated damages amount *reasonable*?

Not a Penalty

A general contractor negotiating a liquidated damages provision must look critically at the amount proposed. Reject it if the amount is clearly intended to penalize defaults, not simply compensate the owner for damages. This is a position that a court will take, and there is no reason to negotiate an unenforceable liquidated damages provision. If the general contractor proves that the amount is so high that it has no relation to the amount of damages that the owner could possibly suffer, then a court would hold that the provision is functioning as a penalty, and would not enforce it (and not award the damages to the owner).

It is very difficult to challenge the damage award in court, however. If the contractor cannot prove that the liquidated damages provision is so unreasonable that it acts as a penalty, he must show that the owner has truly suffered *no* damage at all. Otherwise a court will likely award the liquidated damages sum over the defaulting contractor's objections. After all, the contractor agreed to the stipulated sum in the first place.

It's a Matter of Trust

The general contractor should consider his own comfort level in knowing the price of a default. It may be important to a contractor who is facing an extremely challenging project with a high risk of failure. Or, suppose the owner is not someone the contractor fully trusts, someone who continually changes his specifications without regard for the burdens such changes create, and who still expects the completion date to hold. In this case and others, negotiating a realistic liquidated damages provision may be an important step toward establishing a workable relationship. Such a provision lets the owner know that the contractor is aware of the owner's true downside, at the same time setting a cap on the contractor's liability.

While both contractors and owners may feel more comfortable entering into a construction contract knowing what the price of non-performance will be, the general contractor should understand that a liquidated damages clause is a double-edged sword. While putting a limit on the contractor's potential losses, it makes the owner's recovery of damages easier. ■

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