



# CONSTRUCTION BRIEFINGS

PRACTICAL TIGHT-KNIT BRIEFINGS \* INCLUDING ACTION GUIDELINES \* ON CONSTRUCTION CONTRACT TOPICS

## LIQUIDATED DAMAGES

### Basic Principles and Guidelines

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When a construction contract is not completed on time due to unexcused delays or breach of contract, it is often difficult—if not impossible—to accurately calculate the *amount of damage* experienced by the owner (or contractor, if his subcontractor fails to complete on time). Even where such a calculation can be made, the process is time-consuming and the potential for disagreements between the affected parties which can only be resolved in Court is enormous.

In an effort to eliminate these problems, many owner-contractor and contractor-sub contracts include “Liquidated Damages” clauses which stipulate—in advance of contract performance—the amount for which the delaying or breaching party will be liable. Because this liability can be significant—and because the scope and manner of enforcement of these clauses can themselves lead to disputes—it is important to know the advantages, disadvantages and proper use of “Liquidated Damages” clauses.

This CONSTRUCTION BRIEFING discusses (1) the *standards* governing enforceable provisions, (2) when liquidated damage provisions may be deemed a *penalty*, (3) the *mechanics* of calculating the amount due for the delayed period, (4) variations on the typical clause which can affect your liability, and (5) hurdles and defenses to recovery.

### BASIC PRINCIPLES

**General.** The purpose of a “Liquidated Damages” clause is to establish—in advance of contract performance—a reasonable estimate of the damages that would be incurred as a result of *unexcused delays*, or *breach of contract* which causes the work to extend beyond the completion date. Regarding breach of contract, in the unlikely event the owner is able to replace the breaching contractor with one who finishes by the original completion date, the breach would not be covered by the typical “Liquidated Damages” clause. Since this is a rare occurrence, the term “breach of contract” is used in this BRIEFING to indicate a breach which *does* delay completion of the work.

The reasons for employing liquidated damages provisions fall into two broad categories: they (a) allow you to predict your potential losses (and thus plan work and utilize manpower to control your risk), and (b) improve upon deficiencies in the litigation process.<sup>1</sup> Neither party to a contract particularly relishes the thought of arguing the reasonableness (or unreasonableness) of actual damages, or having a Court determine the amount of damage. Where the amount is uncertain and difficult to estimate, experience has shown that the estimate of a Judge or jury is no more likely to be exact compensation than the advance estimate of the parties themselves.<sup>2</sup>

Under an enforceable "Liquidated Damages" clause, the parties can circumvent the difficulties associated with proving causation and reasonableness of costs, and can reduce the Court's role to deciding the issue of *liability* for the alleged breach. The enforcement of such agreements saves the time of Courts, arbitrators, juries, parties, and witnesses—and eliminates much of the *expense* of litigation.<sup>3</sup>

### Judicial View

Courts today commonly enforce liquidated damages provisions when they are fair and reasonable attempts to determine just compensation for anticipated loss caused by delays or breach of contract.<sup>4</sup> Courts recognize both of the general reasons mentioned above for utilizing liquidated damages, and many opinions note that liquidated damages serve a particularly useful function when damages are uncertain (in nature or amount) or unmeasurable.<sup>5</sup> Other opinions applaud the advance resolution of matters which would otherwise be settled by Courts at greater expense, difficulty, uncertainty, and delay.<sup>6</sup> One Supreme Court opinion pointed out that in construction contracts, a provision giving liquidated damages for each day's delay is an appropriate means of *inducing* proper performance.<sup>7</sup> Overall, due to the increasing complexity of contractual relationships today, liquidated damages provisions have obtained firm judicial and legislative support.<sup>8</sup> In fact, many cases regarding liquidated damages involve public works contracts which *statutorily mandate* the inclusion of liquidated damages provisions.<sup>9</sup>

### Standard Of Enforcement

#### ■ Developed By Courts

Under the two-part test commonly used by Courts to judge enforceability, "Liquidated Damages" clauses will be upheld if: (1) the amount fixed by the clause is a *reasonable forecast* of just compensation for the harm that is caused, and (2) the harm is very difficult (or impossible) to *accurately estimate*.<sup>10</sup>

In other instances, Courts have expressed a third requirement focusing on the *intent* of the parties,

such as "the parties must intend to provide for damages rather than for a penalty,"<sup>11</sup> or stated another way, "there was an intent on the part of the parties to liquidate [damages] in advance."<sup>12</sup> However, neither the intention of the parties nor their expression of intention is always the governing consideration.<sup>13</sup>

Often the "Liquidated Damages" clause will be drafted to closely parallel the standard of enforcement:<sup>14</sup>

If the work is not completed in accordance with the foregoing, it is understood that the Owner will suffer damage; and it being impracticable and infeasible to determine the amount of actual damage, it is agreed that the Contractor shall pay to the Owner as fixed and liquidated damages, and not as a penalty, the sum set out in . . .

#### ■ Restatement Of Contracts & UCC

The *Restatement Of Contracts (2d)*—which is, literally, a "restatement" of the general common law of the U.S., prepared by the American Law Institute and relied on heavily by Courts—describes the following elements to be considered in determining the enforceability of a liquidated damages provision:<sup>15</sup>

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.

This standard is almost exactly the same as the standard contained in the Uniform Commercial Code (UCC),<sup>16</sup> which governs the sale of *goods* in 49 States. The UCC standard is composed of two factors: (a) the amount of damage fixed by the clause must be either a *reasonable forecast* of anticipated damage, or the amount must be reasonable in relation to the *actual* harm, and (b) the amount must be reasonable in light of the difficulties of *proving* the loss.

Both the *Restatement* and the UCC allow the "Liquidated Damages" clause to be judged in terms of what *appeared* to be reasonable at the time the contract was entered into or in terms of the damages *actually* experienced. However, in construction contracting, where damages are often impossible or very difficult to estimate, Courts usually focus only on



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whether the liquidated amount is a reasonable forecast for the anticipated harm. This concept is discussed in greater detail in a later section of this BRIEFING.

## Penalty

The standards of enforcement mentioned above are used to analyze a liquidated damages provision to determine if it is a *penalty*. This is necessary because if the provision is deemed a penalty, it is *unenforceable* as a matter of public policy.

### ■ Definition

A penalty is a sum that bears no apparent relationship to the injury, but is chosen by the party with the greater bargaining position to coerce performance by the other.<sup>17</sup> Most often, Courts state that a "Liquidated Damages" clause becomes a penalty when the amount fixed has a "threatening" effect with no relationship to reasonable compensation for the loss.<sup>18</sup> A valid "Liquidated Damages" clause should merely have the effect of making the injured party "whole" according to the theory of just compensation.

### ■ Tests For A Penalty

In determining whether a liquidated damages provision is actually a penalty, a Court may consider whether the clause was a subject of *negotiation* between the parties. Thus, it has been held that such a provision is unenforceable unless it represents a bona fide attempt by both contracting parties to agree in advance on a reasonable forecast of just compensation for covered claims.<sup>19</sup> However, in many situations—e.g., competitively bid projects—there is no "meeting of the minds" between the parties regarding the liquidated amount. As a result, Courts must consider other factors—such as the *amount* of the liquidated damages in *comparison* to the value of the subject matter of the contract<sup>20</sup>—to test the validity of the provision.

You should note that a "Liquidated Damages" clause is *not* considered a penalty solely because it is labeled a "penalty" or "forfeiture."<sup>21</sup> Conversely, a contract provision is not converted from a penalty to liquidated damages simply by calling it a "Liquidated Damages" clause.<sup>22</sup> Rather, when there is a labeling problem, the Court may consider the sometimes-stated third requirement for enforcement—i.e., the intention of the parties. In so doing, a Court may enforce a clause—even though it is labeled a penalty—when the

intention of the parties to liquidate is clear.<sup>23</sup> However, those Courts following the *Restatement's* standard regarding the use of actual damages may hold a provision to be a penalty despite the initial intention by both parties that the provision is a reasonable liquidation of damages.<sup>24</sup>

### ■ Reasonable Forecast

You may protest that the "Liquidated Damages" clause should not be enforced because the amount of *actual* damages experienced is greatly different from the amount fixed by the *clause*. However, in evaluating the clause, most Courts will only consider whether the liquidated amount was reasonable in light of the circumstances known *at the time of contract execution*.<sup>25</sup> For example, if the "Liquidated Damages" clause is based on rent which must be paid for other facilities if the construction is not completed on time—and the actual rent paid is greatly different from the amount forecast in the clause—most Courts will look at the rental information available to the owner at the time the contract was entered into.

Using this method—i.e., whether the liquidated amount is reasonable in light of the loss anticipated at the time the contract was executed—Courts have held that actual damages suffered which are *less* than the liquidated amount will not cause a provision to be construed as a penalty.<sup>26</sup> Even in situations where there were *no* actual damages, some Courts have upheld the liquidated amount.<sup>27</sup>

Sometimes a contractor on a multi-contractor job argues that no actual damages were incurred—even though he delayed his work—because the *project* was nevertheless completed on time. In one such case, the contractor completed 52 days late, but the project (a highway) opened on time. A claim that no damages were incurred under these circumstances can be misleading because—in order to compensate for the delay—the owner may have incurred additional costs to expedite the work of *follow-on* contractors whose schedules were disrupted.<sup>28</sup>

It has also been held that where actual damages are *greater* than the liquidated amount, the party entitled to the damages is still bound by the liquidated damages agreement.<sup>29</sup>

The majority view is that proof of actual damages is not required for enforcement of liquidated damages unless the contract requires this proof.<sup>30</sup> By entering into the contract, each party took a calculated risk and is bound by any reasonable contractual provisions

pertaining to liquidated damages. Whether actual damages did or did not occur—or were not proved to have occurred—does not prevent enforcement of the provision.<sup>31</sup> Thus, where actual damages are shown to be greatly disproportionate to liquidated damages (or nonexistent) the provision will be enforced. The disparity in damages is not—in and of itself—a conclusive test of a penalty. Rather, the situations in which the liquidated damages provision is held to be an unenforceable penalty are where the disparity indicates that the liquidated sum is not a *reasonable forecast* of damages.

Note, however, that some Courts are starting to look at actual damages at the time of the breach—which avoids the potential unjust enrichment that could occur if the liquidated damages provision is enforced when actual damages are much different from the liquidated sum.<sup>32</sup> Using this method, the determination of whether the liquidated amount is a penalty turns on a combination of the two factors described in the *Restatement*—i.e., whether the amount is reasonable in light of (1) the actual loss, and (2) the difficulty of proving the loss. If the difficulty is great, considerable latitude is allowed in approximating the anticipated harm. Conversely, if the difficulty is slight, less latitude is allowed.<sup>33</sup> [See 1985 Revision Note One.]

#### ■ Type Of Delay Or Breach

Liquidated damage provisions in contracts have been held to be unreasonable forecasts of damages incurred as a result of one type of delay—even though it was a reasonable forecast of a *different* type of delay which did not occur.<sup>34</sup> In the context of construction contracting, a failure of the liquidated provision due to an unanticipated delay can occur where:

- (1) The damages were calculated for delay which might occur *prior* to substantial completion, but were assessed for delays occurring *after* that point;
- (2) The parties agreed to apply actual damages to the delay that occurred;
- (3) The contract is silent regarding whether liquidated damages apply to abandonment or termination; or
- (4) The delay in question is attributable to both contracting parties (concurrent delay).

Since these situations present obstacles to enforcing a clause, they are discussed in greater detail in a later section of this BRIEFING entitled *Obstacles To Recovery*.

#### Mechanics

The expected types of damage which are deemed to fall within the coverage of the "Liquidated Damages" clause depend on the circumstances of the contract work and whether the damages are impossible or extremely difficult to estimate accurately. Anticipated damages may not be limited to those suffered by the contractor. For example, in public works contracts, liquidated damages may cover the inconvenience and loss experienced by the people intended to benefit from the improvement.<sup>35</sup>

#### ■ Calculation Methods

There are various methods used to assess liquidated damages. For instance, nonconstruction contracts often specify that the liquidated damages will be (a) a *percentage* of the total contract price,<sup>36</sup> (b) a percentage of the contract price assessed for *each day* of unexcused delay,<sup>37</sup> or (c) a *lump sum* for failure to perform.<sup>38</sup>

Liquidated damages in *construction* contracts are commonly calculated according to the *per diem* method, where a stipulated sum is assessed for each day of your delay.

#### ■ Payments

Many clauses state that the owner has the right to deduct liquidated damages from progress payments or retainage. Language such as the following may be included:

The owner shall recover said liquidated damages by deducting the amount thereof out of any moneys due or that may become due the contractor.

Note, however, that in the absence of such a provision, the owner may be obligated to pay you in full and then seek recovery through litigation. Conversely, if you accept progress payments reduced by withheld liquidated damages without making a written protest, you may be deemed to have *waived* any right to recover the withheld amounts.<sup>39</sup>

#### ■ Period Of Assessment

Liquidated damages typically run from the planned completion date to the actual completion date—in which the planned completion date is omitted and the actual completion date is included. The *per diem* liquidated amount is generally assessed for each *calendar* day of the delay period. The contract language used may vary from "per day"<sup>40</sup> to more precise language—

such as "per day for each day thereafter, Sundays and holidays included, that the work remains uncompleted."<sup>41</sup>

If your contract duration is set forth in *work days*, you may be assessed liquidated damages on a work-day basis *unless* the calendar-day method is expressly specified in the contract.<sup>42</sup>

#### ■ Starting Date

The starting date for contract performance should be specified in the contract documents or indicated in the Notice To Proceed. If no starting date is specified, the date of scheduled completion may be subject to dispute. This can be very significant, since a dispute over the starting point from which to assess liquidated damages against you may be fatal to enforcement of the clause.<sup>43</sup>

#### ■ Ending Date

The endpoint for assessment of liquidated damages is generally the date of *substantial completion*—i.e., the date work is completed to the extent that the owner may use the facility for the purpose intended.<sup>44</sup> Consideration must be given to the quantity of work unfinished and the extent to which the project was capable of adequately serving its intended use.<sup>45</sup>

At least one case has held that actual—rather than substantial—completion is required to halt the assessment of liquidated damages.<sup>46</sup> In this case, the building was only partially available for use and the liquidated damages were not high. Where the stipulated damages are high and the project is available for use,<sup>47</sup> the doctrine of substantial completion should protect you from such a harsh result.

#### ■ Burden Of Proof

Generally, the party asserting a claim or defense regarding a liquidated damages provision has the burden of proving his assertion. If you are challenging the clause, you have the burden of proving that the amount does not bear a reasonable relation to the possible damages which might be suffered.<sup>48</sup> If the owner is seeking liquidated damages, he has the burden of proving that he has strictly complied with all the requirements for enforcement of the provision.<sup>49</sup>

Although Courts may focus on whether the fixed amount is a reasonable forecast of damages, some Courts have also required the owner to show that actual damages were impractical or extremely difficult

to fix.<sup>50</sup> In addition, a few jurisdictions may require the owner to show that *some* actual damage really occurred in order to be entitled to withhold any sum of money as liquidated damages.<sup>51</sup> [See 1985 Revision *Note Two*.]

#### Alternative Suit For Actual Damages

An owner may not contractually provide for the *option* of recovering either liquidated or actual damages for delay.<sup>52</sup> In addition, an owner cannot substitute actual damages in lieu of a valid "Liquidated Damages" clause.<sup>53</sup> However, there are cases in which—although a "Liquidated Damages" clause is *inapplicable* because, e.g., (1) it is an invalid penalty, (2) the delay was concurrent, or (3) the clause is not applicable to a termination—actual damages *are* recoverable.<sup>54</sup> This places the owner in the position of having to calculate and prove actual damages—a situation he sought to avoid by using the "Liquidated Damages" clause.

In some situations, the owner may seek certain actual damages in *addition* to liquidated damages. In one case, the Court construed the liquidated damages provision as compensating only for delay in performance, and did not interpret it as barring recovery of actual damages for other items to which the provision did not apply. As a result, the owner was able to recover both (a) liquidated damages for the contractor's delay, and (b) actual damages for the contractor's defective work.<sup>55</sup> In another case, the general contractor was required to complete certain portions of an observatory by a scheduled date so that the contractor installing the telescope could begin his work. The general contractor's failure to meet his deadline delayed the telescope contractor, who subsequently filed a claim against the owner for delay damages. The owner recovered from the general contractor both (1) liquidated damages for the delay in completing the entire project (in accordance with the "Liquidated Damages" clause of the contract), and (2) actual damages paid to the telescope contractor.<sup>56</sup>

Language is often inserted in the contract to cover the situation where a liquidated damages provision is deemed unenforceable. This language typically provides that the rights and remedies set forth in the "Liquidated Damages" clause are not exclusive, but are in *addition* to any others provided by law or under the contract.<sup>57</sup> A provision such as this might read as follows:<sup>58</sup>

The liquidated damages referred to herein are intended to be and are cumulative and shall be in addition to every other remedy now or hereafter enforceable at law, in equity, by statute, or under the contract.

### Variations In Clause Coverage

The "Liquidated Damages" clause can be drafted in a manner which varies from the traditional approach in order to provide the owner with a more accurate recovery without being deemed a penalty.

#### ■ Combined Recovery

Generally, a Court will prevent the recovery of both actual and liquidated damages for the same breach.<sup>59</sup> However, the "Liquidated Damages" clause may be structured to allow certain damages to be liquidated, and others to be recovered on the basis of actual expenses—e.g., expenses for litigation, inspection, consulting, etc.<sup>60</sup> An example is as follows:<sup>61</sup>

. . . contractor shall pay, in addition to the liquidated damages hereinbefore specified, all expenses for inspection and superintendence after the date fixed for completion, including all necessary traveling expenses connected therewith.

The key element to consider when drafting such a "combined recovery" provision is to ensure that the liquidated and actual damage elements are "mutually exclusive"<sup>62</sup>—since ambiguities and double recovery are grounds for invalidating the liquidated portion of the provision.<sup>63</sup>

If a provision for liquidated damages does not expressly authorize both categories of damages by specifying certain elements of actual damages, it may be construed as allowing both—as the cases in the previous section illustrate. This scenario occurs where the liquidated provision is read as applying only to delays, *and* actual damages unrelated to delayed use of the project are also sought by the owner, *or* actual damages are authorized in addition to liquidated damages, but very broad language is utilized. Cases involving termination or abandonment—which provide a wealth of inconsistent results involving combined recovery—will be discussed in a subsequent section.

#### ■ "Bonus" Clause

Another variation of a "Liquidated Damages" clause is found in *incentive* contracts, where a "Bonus" clause is coupled with the liquidated damages provision. Under this variation, you are entitled to receive a bonus for each day the project is completed *ahead* of schedule. Bonus provisions are commonly employed by developers of commercial and residential properties. One significant aspect of a "Bonus"

clause is that it may be strong evidence of the reasonableness of the liquidated amount.<sup>64</sup> The bonus creates an appearance of "bargained for mutuality," a factor to be considered in analyzing the enforceability of the provision.<sup>65</sup>

A common misconception is that a "Liquidated Damages" clause *must* be accompanied by a "Bonus" clause. The addition of the bonus provision is not required as a means of offsetting the liquidated damage provision; rather, as noted previously, liquidated damages are inserted instead of actual damages.

#### ■ Ceiling On Damages

As noted above, if the delay period is substantial, the cumulative liquidated damages sum may also be substantial. In these situations, a Court may compare the assessed amount of liquidated damages to the total contract price and hold the provision unenforceable. However, the contracting parties can, by agreement, limit their liability in damages to a specified amount<sup>66</sup> by, e.g., limiting damages to a fixed amount,<sup>67</sup> or placing a cumulative ceiling on damages which corresponds to a percentage of the contract price.<sup>68</sup>

#### ■ Substantial Completion

As discussed previously, substantial completion of the work usually stops the assessment of liquidated damages because its occurrence will allow "beneficial occupancy"—i.e., use of the structure. If final completion is delayed, however, the construction may not be available for *all* contemplated uses. Although an owner may attempt to withhold liquidated damages after substantial completion and before final completion, the liquidated amount will probably be deemed a penalty since the actual damages during the period between substantial and final completion are disproportionately lower and the liquidated amount was a reasonable forecast of damages anticipated *prior* to substantial completion.<sup>69</sup>

To avoid this situation, the liquidated amount can vary and can be tied to milestones throughout the project. Adjusting the damages for the time before substantial completion and for the period between substantial and final completion results in a "two-tiered" liquidation of damages. The liquidated amounts for each phase should reflect the probable damages that would be incurred as a result of delay in each phase. [See 1985 Revision *Note Three*.]

## Obstacles To Recovery

Both parties to the contract must be aware of the factors affecting the enforcement of liquidated damages. Such factors may arise due to the drafting of the clause, the conduct of the parties, or the circumstances surrounding use of the clause. An owner will want to be aware of any obstacles to his recovery of liquidated damages, and you will want to know of any possible defenses you may have to the assessment of liquidated damages.

The language utilized in the clause or the manner in which the provision operates may cause the provision to be ruled unenforceable. As stated in previous sections, this problem may arise when the clause (1) is held to be a penalty due to an unreasonable forecast, (2) is applied to an unanticipated delay, (3) contains a dual allowance for actual damages, (4) is applied to a disputed starting date, or (5) gives the owner the option of choosing between different remedies. The following conditions may also thwart the enforcement of a liquidated damages provision.

### ■ Owner Conduct

An owner's claim for liquidated damages may be barred due to his active interference or unreasonable conduct relating to the delay.<sup>70</sup> In one Court opinion, the rule was stated quite well:<sup>71</sup>

A contractor is not liable under a clause for liquidated damages based on a time limit if his failure to complete the contract within the specified time was wholly due to the act or omission of the other party in delaying the work, whether by omitting to provide the facilities or conditions contemplated in the contract to be provided by him, or by those for whom he is responsible, or by interfering with the work after the contractor has begun, or otherwise.

Following the theory of just compensation, an owner's failure to *mitigate* (minimize) damages may also cause the liquidated damages provision to be ruled unenforceable.<sup>72</sup> The issuance of a change order by the owner at a point in time *beyond* the scheduled completion date may also present a situation where recovery of liquidated damages for prior nonexcusable delay could be barred.<sup>73</sup> Owners attempt to protect themselves in this situation, however, by including language in each and every subsequent change order reserving their right to liquidated damages.<sup>74</sup>

### ■ Waiver

Other factual circumstances which present a situation where the owner may waive his right to liquidated damages include accepting your work (or occupying the project) on or before the date of scheduled

completion. In addition, if either of these events occurs *after* the date of scheduled completion, the owner may waive his right to *continue* assessing liquidated damages.<sup>75</sup>

Just as you can waive your right to recover withheld amounts, the owner can waive his right by *failing to claim* liquidated damages prior to final payment.<sup>76</sup> To prevent his rights from being waived, the owner typically provides the contractor with notice of his intention to withhold the liquidated amount from any money due the contractor.

The "waiver" argument is not always successful. For example, failing to terminate the contract after the completion date had passed—and allowing the contractor to complete—may be held *not* to be a waiver.<sup>77</sup> In a case involving a Federal Government contract, the surety argued that it did not agree to pay liquidated damages when it took over performance for the defaulted contractor, since the Government's act of allowing the surety to complete the work without a takeover agreement constituted a waiver of liquidated damages. However, it was held that the absence of a takeover agreement did not show an intention to waive liquidated damages and the surety was, therefore, liable under the terms of the original contract.<sup>78</sup>

### ■ Excusable Delays

It is a fundamental rule that the period for assessing liquidated damages will be reduced by any *extensions of time* to which you are entitled for excusable delays. Much of the owner's conduct previously cited for active interference will fall into this category.

If you do not comply with contractual provisions regarding extensions of time for excusable delays—e.g., notice provisions—liquidated damages may be awarded for periods that would otherwise have been omitted.<sup>79</sup> Similarly, in a situation where you claim that liquidated damages should be denied due to *concurrent* delay (discussed below), they will nevertheless be assessed if you fail to comply with provisions regarding requests for additional time as a result of owner-caused delay.<sup>80</sup>

### ■ Concurrent Delay

Historically, Courts have refused to apportion delay (and thus, the liquidated damages) where both the contractor and owner contributed to delaying the work.<sup>81</sup> Contractors sought to avoid the assessment of liquidated damages by invoking this so-called "rule

against apportionment"<sup>82</sup>—which states that rather than apportioning the fault, the owner forfeits all right to recover under a "Liquidated Damages" clause where he has contributed to delays on the project.<sup>83</sup>

Note that this rule has been adopted by some jurisdictions, but rejected by others. And some Courts, though denying apportionment, state that they *would* have apportioned responsibility—and thus assessed liquidated damages—if there had been a *contract provision* requiring such apportionment.<sup>84</sup>

Two justifications for the rule against apportionment are (1) early judicial hostility toward liquidated damages provisions and (2) the difficulty of proving how delay should be apportioned.<sup>85</sup> One Court, after denying apportionment, stated that even in those jurisdictions allowing it, apportionment will depend on the situation of the particular case and whether apportionment could feasibly be made.<sup>86</sup> The erosion of the first rationale for denying apportionment has already been discussed, and there are persuasive arguments for the erosion of the second.

Some jurisdictions have adopted the contemporary approach of enforcing liquidated damages despite concurrent fault for delay.<sup>87</sup> The holdings of early cases in these jurisdictions were based on a literal construction of the contract provision. If the contractor had agreed to pay for each day's delay "not caused by the owner," the intention was clear that the contractor should pay liquidated damages for the delays other than those caused by the owner.<sup>88</sup> Apportionment cases recognize that, although the fault of the respective parties may not be clearly distinguishable in time and it may be difficult to estimate how much of the delay is attributable to each party, this should not bar recovery by the owner in every case.<sup>89</sup>

The response to denying apportionment of damages because they simply are too difficult to prove, can be summed up by a quote from the opinion of one Court:<sup>90</sup>

Categorical statements that where delays are caused on both sides there is no way to apportion damages are an absurdity. Damages are not being apportioned. Damages are liquidated. Quantum of delay in terms of time is all that is being apportioned. That is an uncomplicated fact finding process. That is what Courts are for.

Often the apportionment of delay time is accomplished by simply denying the owner liquidated damages for periods of owner-caused delays, as the Court may determine.<sup>91</sup>

There are two levels of apportionment which a Court must perform: (a) the apportionment of the number of days of delay attributable to each individual cause of delay, and (b) an apportionment of fault (i.e., which of the two parties is responsible for the individual causes of delay). If unable to make this determination, the Court may simply split the fault—and thus the time—between the parties.<sup>92</sup> One recent case, after highlighting the divergence of cases on the issue of apportionment and analyzing some of them, decided that—in light of current case law—the better rule is that the law is clearly in favor of apportionment of liquidated damages in the context of concurrent delay.<sup>93</sup>

Before allowing apportionment of delay and the award of liquidated damages, some Courts may require other elements to be satisfied, such as requiring the owner to demonstrate that his delay was not incurred in bad faith,<sup>94</sup> or that it was noncritical at the time of occurrence.<sup>95</sup> Conversely, you may be able to avoid the assessment of liquidated damages by showing that the owner's delay was on the critical path of the project schedule in effect at the time the delay occurred.<sup>96</sup> [See 1985 Revision *Note Four*.]

#### ■ Inequitable Defense

Several Florida decisions involving real estate transactions have developed a rule which allows a "Liquidated Damages" clause to stand if the damages are not readily ascertainable at the time the contract is drawn, but will deny enforcement if the stipulated amount appears unconscionable in light of the circumstances existing at the time of the *breach*.<sup>97</sup>

These cases were relied upon as precedent in a subsequent construction contract case in Florida in which the Court denied liquidated damages a prime contractor was seeking from one of his subs.<sup>98</sup> The Court did *not* find the clause to be a penalty; rather, it held that enforcement of the clause would be *inequitable* in light of the actual damages the contractor was allowed to recover. The approach taken by this Court is similar to the view (discussed previously) that the comparison between actual and liquidated amounts should be performed from the perspective of the time of the breach.<sup>99</sup>

The underlying basis for employing liquidated damages rests upon the reasonable assumption—at the time of contracting—that actual damages will be difficult to determine. The approach taken by the Florida Court provides a route toward more equitable results when that assumption later proves to be inaccurate—i.e., when there is clear proof of actual damages and

they are disproportionate to the recoverable, liquidated forecasts. This new approach may well provide a valuable defense for contractors in other States in the future.

### Abandonment & Termination

Where you abandon the project or the owner terminates your performance—and the contract does not cover these circumstances—Courts have reached divergent results. Even when these situations are covered by the liquidated damages provision, the results may vary depending on the Court's interpretation of the clause.

There are several rationales for denying liquidated damages to the owner in the case of abandonment or termination. All of them can be generalized to say that it simply was not contemplated by the parties to have the liquidated damages provision apply in these circumstances.

#### ■ Terminations

Some of the earliest termination cases involved Federal Government contracts which contained a liquidated damages provision which gave the Government the option of (a) terminating the contractor, or (b) allowing him to complete late and collect liquidated damages. Courts have held that since the contractors were terminated, the Government had chosen its option, and liquidated damages were denied.<sup>100</sup>

Other early cases interpreted the language of the clause to condition the award of liquidated damages upon the contractor's completion of the work. Since the provision contemplated the contractor's *delay* in completion, and the contractor *never* completed, the liquidated damages were denied.<sup>101</sup> Another way of reaching the same result is for the Court to hold that

the owner—by terminating the contractor—took the completion date (or the endpoint for the assessment of liquidated damages) out of the contractor's control.<sup>102</sup>

#### ■ Abandonment

Some Courts have held that the "Liquidated Damages" clause is *voided* by the contractor's *abandonment* of the work. Thus, the owner can recover *actual* damages from the contractor, which—in the case of abandonment—can be significantly *greater* than the amount allowed under the clause.<sup>103</sup>

On the other hand, one Court—in deciding whether to award liquidated damages in a case where the contractor abandoned the work and the *owner* completed performance—held that the "Liquidated Damages" clause was *not* voided by the contractor's action. In this instance, the owner was entitled to recover damages for the period of time he could show that the contractor *would have* consumed had he not abandoned performance.<sup>104</sup> The owner could meet this burden by using the contractor's rate of progress before abandonment.

In most cases of abandonment, the owner will hire another contractor to complete the project—usually incurring increased costs in the process. In this situation, the owner is still entitled to liquidated damages from the original contractor for the delay in completion, since it is likely that the follow-on contractor will not complete before the scheduled completion date.

If the amount prescribed by your clause is intended as a liquidation of the damages for injury caused by failure to obtain the *use* of the project on time, it should not affect the recovery of actual damages for increased costs of completion.<sup>105</sup> The owner may reserve his right to recover these increased completion costs as well as liquidated damages.<sup>106</sup>

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## GUIDELINES

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These *Guidelines* are intended to provide you with practical advice pertaining to liquidated damages. They are not, however, a substitute for professional representation in any specific situation.

1. Anticipated damages should be carefully calculated in order to satisfy the "reasonable forecast" requirement of a valid liquidated damages provision. Documentation of any calculations made to arrive at the per diem sum should be preserved in the event the amount is later challenged.

2. Although the manner in which the liquidated damages provision is labeled is not conclusive of its

character, it is best not to refer to the provision as a *penalty*. Most clauses, in fact, state that the sum to be paid is for "liquidated damages, and not as a penalty."

3. Language may be included (a) allowing liquidated amounts to be withheld from any *payments* due the contractor, and (b) reserving the right to sue for liquidated damages if *retainage* is insufficient for a set-off.

4. The contract should specify whether *working* days or *calendar* days are to be included in the period of assessment. It is best to be specific about whether

Saturdays, Sundays and holidays are included or excluded. This stipulation should read the same in the general and supplementary conditions of the contract to be enforceable.

5. The commencement date for the contract work—as well as the number of days allotted for the work—should also be clearly set forth in the contract so that there is an undisputed date of scheduled completion to mark the starting point for assessment of the *per diem* amount.

6. The endpoint for assessment of liquidated damages should be defined, whether it be substantial completion or final completion. If the endpoint is not specified in the contract, *substantial completion* normally applies.

7. If the contract clause contains language preserving the owner's right to file an alternative action for breach of contract, the clause may be held unenforceable—in which case, the owner will have to seek *actual* damages in his suit.

8. It is important to obtain *extensions of time* for all excusable delays which will reduce the period of assessment. You should also be sure to comply with any notice and application provisions regarding extensions of time—the failure to do so may result in a *denial* of the extension.

9. Both parties to the contract should be aware of conduct which may waive their rights regarding liquidated damages. For example, the owner's acceptance of the work will constitute an endpoint for liquidated damages, thus waiving the owner's right to any further assessment. The owner could also waive his right to recover liquidated sums by failing to assert a claim

for them before making final payment. On the other hand, you could waive your right to recover any withheld liquidated damages by *accepting* payments from the owner which are *reduced* by the withheld amounts, without making a written protest.

10. If liquidated damages are to be assessed *beyond* substantial completion, the two-tier approach—where the amount of liquidated damages is adjusted downward for the post-substantial completion period—should be used so that the *per diem* amount fits the probable damage.

11. Where the contract so provides or where there is legal precedent to do so, *concurrent delays* can be *apportioned* by examining the impact of the delays on the project schedule and their effect on the critical path. Otherwise, the general rule is that if concurrent delays occur, the owner cannot recover any liquidated damages.

12. The liquidated damages provision may single out certain damage elements (e.g., attorney's fees) to be recovered as *actual* damages, but should not provide an *option* between the two types of damages nor provide for double recovery.

13. The contract should dictate how liquidated damages are to be assessed in a situation of *abandonment* or *termination*. For example, the contract may provide that liquidated damages should (a) not apply, (b) be assessed only until the date of termination or abandonment (if that date is after scheduled completion), or (c) be assessed for the entire delay in completion by a follow-on contractor. The owner may also insert language allowing him to recover not only liquidated damages for delay but also actual damages for increased cost to complete.

#### ★ REFERENCES ★

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# 1985 REVISION NOTES Liquidated Damages

## NOTE ONE

### ■ Reasonable Forecast

Courts' methods of determining the reasonableness of the amount of forecasted liquidated damages continue to vary. In *E.F. Solomon v. Dept. of State Highways & Transportation*, 345 N.W.2d 717 (Mich. 1984), 8 C.C. ¶216, for example, the Court determined whether the amount stipulated as liquidated damages was reasonable by looking to the conditions at the time the contract was entered into, not the conditions at the time of the breach of the contract.

In *Ledbetter Brothers, Inc. v. N.C. Dept. of Transportation*, 314 S.E.2d 761 (N.C. 1984), however, the Court went one step further in testing the reasonableness of the liquidated sum by comparing it to the amount of the damages that had actually been caused by the breach. The Court upheld the "Liquidated Damages" clause, and noted that any disproportion between the amount of liquidated and the amount of actual damages "must be such as to shock the judicial conscience for a penalty to be found."

## NOTE TWO

### ■ Burden Of Proof

When a contractor challenges the assessment of liquidated damages against him by the owner, the owner has the burden of proving that the liquidated damages are owed to him. Once the owner has established, however, that (1) the contractor failed to meet the contract completion date, and (2) the period of assessment is appropriate, the burden shifts to the contractor to show why the failure to complete the project on time was excusable. In *Sauter Const. Co.*, ASBCA 27050, 27 G.C. ¶11, 84-2 BCA ¶17288, the contractor failed to meet this burden, but did not show that a final inspection by the owner (the Government)—at a time when only punch list items remained to be performed by the contractor—was not made since the Government inspector was not available. The Board held that since liquidated damages cannot be assessed beyond the time of substantial completion of the project—which in this case was when only punch list items remained—the Government failed to meet its burden of proof and was not entitled to liquidated damages.

## NOTE THREE

### ■ Substantial Completion

In a recent case, a Court upheld a "two-tiered" liquidated damages provision. In *Solomon v. Dept. of State Highways & Transportation*, 345 N.W.2d 717 (Mich. 1984), 8 C.C. ¶216, the "Liquidated Damages" clause in a contract for highway construction provided for damages of \$300 per day for each day beyond the comple-

tion date that the highway was not open for traffic, and \$150 per day for each day beyond the completion date that the project remained incomplete. Furthermore, the clause provided for varying liquidated sums depending on the original contract amount. The Court held that the provision was reasonable, considering the original contract amount and the difficulty in determining actual damages.

Liquidated damages assessed after substantial completion of a project will not necessarily be construed as a penalty. In *Ledbetter Brothers, Inc. v. N.C. Dept. of Transportation*, 314 S.E.2d 761 (N.C. 1984), for example, \$300 per day was assessed as liquidated damages beyond substantial completion until final acceptance of the project. The Court upheld the assessment, noting that (1) some of the contemplated damages were costs that would be incurred between substantial and final completion, (2) interpretation of various contract provisions indicated that the parties intended that liquidated damages would be assessed until final completion, and (3) the public policy behind liquidated damages should not be frustrated by allowing disputes over substantial performance to effect the contract's provisions.

## NOTE FOUR

### ■ Concurrent Delay

New York is one State that still follows the "rule against apportionment." In *Babylon Assocs. v. County of Suffolk*, 475 N.Y.S.2d 869 (1984), the Court held that although generally the owner's exclusive remedy for delay damages is the "Liquidated Damages" clause, where the delays are caused by the mutual fault of the parties, the owner forfeits his right to liquidated damages and must resort to seeking actual damages.

### ■ "Conduit" Clause

In the same way that a liquidated damages provision may limit your liability, it may also limit your recovery from another party. A contract between a prime contractor and a subcontractor may contain what is known as a "Conduit" clause. Such clauses are designed to incorporate into the *subcontract* the provisions of the contract between the prime contractor and the owner.

In *Industrial Indemnity Co. v. Wick Const. Co.*, 680 P.2d 1100 (Alaska 1984), the general contractor withheld final payment from a subcontractor for delayed completion. The prime contract contained a "Liquidated Damages" clause stipulating liquidated damages of \$400 per day of delay. The subcontract contained a "Conduit" clause. The Court held that the subcontractor's liability was limited to the liquidated amount of \$400 per day of delay, an amount less than the actual damages the prime sought to recover.