



“Think Ahead About Contract Damages”

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Real estate developers and contractors are optimists. How else to explain their involvement in businesses which expose them to so much risk, and where so many things can go wrong? Nevertheless, even the most unabashed optimist involved in a construction project as a developer or contractor, should give some advance thought to the types of damages which they may recover, or which they may have to pay, in the event of a breach of a construction agreement. There are two types of damages which parties negotiating a construction contract should consider: 1) consequential damages beyond traditional direct costs, and 2) liquidated damages.

CONSEQUENTIAL DAMAGES

Consequential damages are indirect (vs. direct, out-of-pocket) costs which are caused by breach of a construction contract. Classic examples of consequential damages to an owner are lost profit or business advantage resulting from incomplete or delayed work; financing related damages resulting from an increase in interest rates or extended financing over a greater period of time; or professional or consulting fees springing from a contractor's default. A contractor's consequential damages may include lost profit on other projects or lost business advantage on other projects caused by restrictions to its bonding capacity, or extended overhead costs caused by project delay.

Prudent owners and contractors will include language in their construction contracts dealing with the recovery of consequential damages. A developer or contractor should decide whether the parties want to include the potential recovery of consequential damages. The standard form AIA A201 General

beyond their direct out-of-pocket expense, in the event that their construction contract is breached. Appropriate drafting of the contract can protect their respective interests.

LIQUIDATED DAMAGES

Liquidated damages are a mechanism used by owners to establish, in advance, damages resulting from project delay. By definition, liquidated damages replace actual damages or consequential damages caused by delay. They are used when an owner's actual damages are inherently difficult to quantify, or cannot be accurately predicted in advance. Liquidated damages can be set in a contract as a specific gross amount, or in an amount calculated under a formula, typically on a daily basis. If an owner's damages ultimately exceed the liquidated damages amount, most courts will limit the owner's recovery to the agreed upon liquidated damages. If the liquidated damages grossly exceed the actual damages, it is possible that a court may refuse to enforce the liquidated damages because they are considered a penalty.

Since an unknown project delay is the trigger for imposition of liquidated damages, both an owner and contractor negotiating a construction contract must give advance thought to whether liquidated damages should be used, and if so, in what amounts. A contractor asked by an owner to agree to liquidated damages should attempt to estimate an owner's actual damages for delay so as to agree only to a reasonable amount of liquidated damages. A contractor should also avoid so-called "no damage for delay" clauses, which limit its remedy for project delay to an extension of time. An owner should not simply pick a liquidated damages number "out of the air", but rather should try and tie its liquidated damages amount to the amount of actual damage that it thinks, in good faith, it may incur. The peril for an owner is that if it underestimates liquidated damages, it may not recover its actual costs for project delay, but if its liquidated damages amount is grossly overstated, a court may refuse to enforce it. The decision to use and make liquidated damages enforceable is a difficult one.