

Liquidated Damages Are a Part of Many Contracts

By Robert B. Jacobs

Contractors and subcontractors are constantly being presented with contracts for their review on projects that they are working on or bidding. Because many contractors negotiate their own contracts, there is a substantial value in understanding some of the common contractual terms.

One clause which is commonly used in many contracts is a provision for “Liquidated Damages.” This can be confusing but the concept is actually quite simple. When a contract breach occurs, the non-breaching party is entitled to recover any damages which he or she has suffered because of the breach of the contract. However, it can sometimes be both difficult and expensive to prove the exact nature and amount of damages that have been suffered. The law requires the damages be proven with certainty or otherwise they are not recoverable. This means that even if a party has been damaged by a breach, that party may not be able to recover damages if that party can’t prove exactly how much damage that party has suffered.

A good example of damages which are difficult to prove is a claim for delay in a construction project. Because of commitments to other projects and because of staffing issues, a delay in a construction project can have a domino effect that can be very expensive for a contractor if he or she is not able to proceed with the work of improvement at the agreed upon time. However, proving these delay claims can be very time consuming and expensive. In order to prove such delay damages, a contractor would need to assemble all of the documentation showing the contractor’s expenses on the job, and then the contractor would be required to demonstrate how those expenses would all have been less had there been no delay. This can be a time consuming project.

One way that contractors and owners address these complex proof issues is the use of a contract clause for “Liquidated Damages.” The phrase “Liquidated Damages” simply means that the parties have agreed as to the amount of damages that will be suffered by a party in advance of a breach. There can be several reasons for doing this. One of the reasons is certainty, so that a breaching party will know what the upper limit of their liability is if they choose to breach the contract. Another reason can be to provide an incentive to finish a job. If a party knows that they will be liable for liquidated damages, then much of the guess work is removed as to the amount of liability they will have should they decide not to finish their contract.

An example of the use of a liquidated damages clause would be where a contractor enters into a contract to complete a project by a specific date. The contract may contain a provision that states that if the contractor should not finish their work by that date then the owner will be entitled to a payment of a specific dollar amount for each day the project remains incomplete past the completion date. This is one form of “Liquidated Damages.” The use of a liquidated damages clause in such a situation makes it unnecessary for the owner to demonstrate exactly how much the owner was damaged

by this construction delay. It also lets the contractor know in advance the amount of the contractor's liability if the job is not completed on time.

Liquidated damages in any situation may be unenforceable if the amount of the liquidated damages was unreasonable at the time the contract was entered into. In most situations, the law prefers courts to award actual damages instead of liquidated damages and therefore in order to recover liquidated damages it may be necessary to demonstrate that it was extremely difficult or impossible to prove with certainty the actual damages that were incurred. A liquidated damages clause in almost all cases must be reviewed in the context of the entire project, and if the clause was reasonable at the time it was entered into, and if the actual damages were extremely difficult to determine, then the chances are good that the liquidated damages clause will be upheld in court.

Special rules apply to sales of real estate. For example, if a contract for sale of residential real property provides that the liquidated damages will be no more than three percent of the purchase price, and if the deposit paid by the buyer is to serve as the source of funds for recovery of the liquidated damages, then a liquidated damages clause is presumed to be valid. Additional special rules apply to the sales of condominium units.

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