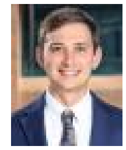
WARD AND SMITH, P.A.
ATTORNEYS AT LAW

Issues Impacting Enforceability of Liquidated Damages in Construction Contracts

Written By **Luke C. Tompkins** (lctompkins@wardandsmith.com)
October 23, 2020



Liquidated damages are a sum specified in a contract as the measure of recovery in the event of a breach of the contract.

Liquidated damages provisions are common in construction contracts to guard against damages that the owner or a contractor might suffer if a project is delayed beyond the completion date set forth in the contract. These provisions appear in both public and private construction contracts. Oftentimes, the owner of a construction project will include a liquidated damages provision in the prime contract with the general contractor. The provision might state, for example, that if the project is delayed beyond the required completion date, the owner may assess against the general contractor liquidated damages in the amount of $1,000.00 per day until the project is complete. The general contractor, in turn, will likely include a similar clause in its subcontracts passing along the risk of liquidated damages to its subcontractors if delays to the completion of the project are caused by the acts or omissions of the subcontractor.

Liquidated damages provisions are helpful because they establish the damages for construction delays at the outset of the project and eliminate the need to prove actual damages. The party whom the liquidated damages clause benefits need only prove that the performing party delayed completion of the project to be entitled to recover the amount of damages listed in the contract. In the absence of a liquidated damages provision, to recover damages for delay, an owner or contractor has to prove both that the contractor delayed the project and the actual damages that were caused by the delay. Demonstrating actual damages is a difficult task that requires detailed proof that ties the loss to the period of undue delay with reasonable certainty. Thus, being able to rely on liquidated damages for delay provision can be quite useful.

Liquidated damages clauses are generally enforceable, but most courts will not enforce a liquidated damages provision if (1) it constitutes a penalty as opposed to a reasonable estimate of the actual damages likely to be incurred due to delay, or (2) the party benefitting from the liquidated damages clause is responsible for a portion of the delay to completion of the project and the contract does not provide for apportionment of damages in the case of mutual delays.

I. Liquidated Damages vs. Unenforceable Penalty

North Carolina courts recognize a two-pronged test for determining whether liquidated damages are enforceable or constitute a penalty: (1) the damages from the breach of contract must be difficult to ascertain as of the time the parties entered the contract; and (2) the amount of damages stipulated must either be a reasonable estimate of the damages which would probably be caused by a breach or reasonably proportionate to the damages actually caused by the breach. If the party disputing liquidated damages can prove either that actual damages were not difficult to ascertain or that the liquidated damages were not a reasonable estimate of actual damages and were not reasonably proportionate to the actual damages, the liquidated damages provision will not be enforced.

To show that damages were not difficult to ascertain, the party opposing liquidate damages has to show that there was a clear, objective basis for measuring all aspects of the actual damages that might result from the breach. This is an extremely steep challenge in the context of liquidated damages for delays to construction projects. First, North Carolina courts give substantial weight to stipulations by the parties in the contract that damages are difficult to ascertain. Therefore, if the contract includes a clause stating that both parties agree the measure of damages that will result from project delays is difficult to ascertain, this will usually suffice to demonstrate that damages were in fact difficult to ascertain. Second, courts often find that damages are difficult to ascertain when the project at issue is complex or involves a large undertaking, as is often the case with construction projects. Lastly, delays in the completion of construction projects generally bring in to play many potential items of damages, including lost profits due to not opening the completed project on time, continued costs associated with operating other facilities that the project was meant to replace, increased costs of construction, etc. Thus, it is unlikely that the party opposing liquidated damages for delays on construction projects will be able to show that damages were not difficult to ascertain at the time of contracting.

To demonstrate that liquidated damages are not a reasonable estimate of actual damages and that they are unreasonably disproportionate to actual damages, the party opposing liquidated damages must show that there was no reasonable attempt to estimate damages prior to contracting and that liquidated damages are shockingly excessive when compared to the actual damages suffered and the overall value of the contract. As with the first prong, courts will generally defer to the parties if the parties stipulate that the amount of liquidated damages is a reasonable estimate of the damages that will likely result from delays to project completion. If such a stipulation exists, this will be difficult to overcome, so contractors and subcontractors should refuse to sign such a stipulation if you believe the amount of liquidated damages is unreasonable.

Next, because liquidated damages are meant to approximate actual damages, courts will consider whether the liquidated damages amount is based on a reasonable estimate of actual damages made by the owner or contractor, or whether the liquidated damages amount was simply a random arbitrary amount. Lastly, the court will look to whether liquidated damages are shockingly disproportionate to actual damages. Courts have held that liquidated damages twice the amount of actual damages were reasonably proportionate to actual damages. Thus, the party opposing liquidated damages will need to show that liquidated damages far exceed actual damages to succeed in having them ruled an unenforceable penalty.

In conclusion, contractors or subcontractors opposing liquidated damages for delays to construction projects face a difficult task in demonstrating that a liquidated damages clause is an unenforceable penalty. It is nearly impossible to show that delay damages were not difficult to ascertain at the time of contracting. However, if the contractor or subcontract can show that the liquidated damages amount was an arbitrary amount that far exceeded actual damages, a court may conclude that the liquidated damages constitute an unenforceable penalty. On the other hand, owners and contractors can likely avoid having liquidated damages for delay clauses overturned as unenforceable penalties if the liquidated damages amount reflects a sincere attempt to estimate actual damages and their contract includes stipulations that actual damages are difficult to ascertain and that the liquidated damages amount is a reasonable estimate of actual damages.

II. Mutual or Concurrent Delays by Contracting Parties

Under North Carolina law, it is clear that the party benefitting from a liquidated damages provision cannot recover liquidated damages if it is responsible for all of the delays to the project. In addition, North Carolina law states that liquidated damages are unenforceable if the party benefitting from the liquidated damages was itself responsible for a portion of the delays to project completion unless the contract contains a clause providing for apportionment (i.e. division) of liquidated damages in the case of mutual delays. This rule, which I'll refer to as the "Non-Apportionment Rule," was recognized by the North Carolina Supreme Court in 1967. Under the Non-Apportionment Rule, if the owner or contractor whom the liquidated damages clause benefits is responsible for any amount of the delays to project completion, they cannot recover liquidated damages unless the contract authorizes project delays to be apportioned between the parties so that liquidated damages can be assigned to the contractor or subcontractor based on the delays they are responsible for. In other words, an owner's or contractor's responsibility for a portion of the project delay can result in not being able to recover liquidated damages for delays caused by the performing party. Notably, there is a trend among other jurisdictions away from the Non-Apportionment Rule because some courts have found it to be overly harsh. North Carolina's Non-Apportionment Rule, however, has never been overruled and was applied by the North Carolina Court of Appeals as recently as 2007.

Based on the Non-Apportionment Rule, mutual delays can serve as a basis for complete avoidance of liquidated damages where the contract does not authorize apportionment of liquidated damages. Thus, parties seeking to avoid or enforce liquidated damages should be aware of the Non-Apportionment Rule. Owners or contractors seeking the benefit of liquidated damages provisions should consider including a provision in your contract for apportionment of liquidated damages in the case that both parties are responsible for delays (*i.e.* there are mutual or concurrent causes of delay). If an apportionment clause is included in the contract, the performing party should negotiate for any apportionment of delays to be administered by a neutral third party, so as to eliminate any bias in dividing the delays among the parties. If it is not included, the performing party should seek to prove mutual delays as an avenue to avoid liability. In either case, both parties should be sure to document and collect evidence of all delays which you contend the owner, contractor, or a subcontractor has caused to the project as you may need this evidence to either establish your right to liquidated damages or to escape or minimize your liability for liquidated damages.

Conclusion

In conclusion, liquidated damages clauses provide a helpful remedy to the party harmed by delay in circumstances where calculating actual delay damages is difficult. Liquidated damages, however, will not be enforced if they do not reflect a reasonable estimate of actual damages and are grossly excessive in comparison to actual damages. Additionally, unless the contract provides otherwise, liquidated damages for delays will not be enforced by the courts if the party seeking enforcement is responsible for some of the delay at issue. Participants in the construction industry should keep these issues in mind when negotiating and entering into construction contracts.

--

Luke C. Tompkins.

This article is not intended to give, and should not be relied upon for, legal advice in any particular circumstance or fact situation. No action should be taken in reliance upon the information contained in this article without obtaining the advice of an attorney.

We are your established legal network with offices in Asheville, Greenville, New Bern, Raleigh, and Wilmington, NC.