

Understanding Liquidated Damages

The law is difficult to understand, whether you are an accountant, actuary, pipefitter, or plumbing contractor. Yet, the law intimately affects each of these trades in areas such as liability, regulations, and transactions. In an effort to simplify liability issues for plumbing engineers, designers, and contractors, this column will cover general-interest legal topics and attempt to explain them through the use of everyday examples and hypothetical cases. It will attempt to act as a “pipeline” between you, the non-attorney plumbing industry professional, and various legal concepts.

ATLANTIC YARDS

The \$4 billion Atlantic Yards Arena and Redevelopment Project is an ambitious, 22-acre development consisting of several blocks of residential and commercial structures, mass transit facilities, and an 18,000-seat, Frank Gehry-designed sports arena (Barclays Center) that will serve as the future home of the National Basketball Association’s New Jersey Nets. In addition to the arena, the project will have 16 high-rise apartment and office buildings, a 180-room hotel, and eight acres of publicly accessible open space.

The developer, Forest City Ratner Companies, LLC (FCRC), conceived the Atlantic Yards project in mid-2002 and announced it to the public at a press conference in December 2003. Since that time, the project has been plagued by numerous delays resulting from municipal approvals (by the transit authority, city, state, and community officials), as well many court challenges (predicated on environmental claims and eminent domain, or the government’s right to take private property for a public use).

According to the FCRC Executive Vice President in charge of the project, MaryAnne Gilmartin, delays in the progress of construction cost FCRC millions of dollars. These delay costs include carrying costs for the property (approximately \$2.4 million per month), operating losses for the Nets (resulting from staying in New Jersey instead of moving to Brooklyn), cost escalations (for labor and materials), and transit facility-related costs (\$300,000 per month). These costs do not even include prospective delay claims from construction contractors (who might have to stop work, demobilize, and restart work following a delay). In early May of this year, the developer’s principal predicted that the entire Atlantic Yards project would be completed by 2018.

While this story about Atlantic Yards may offer an interesting lesson in civic redevelopment, you may be wondering, “What does any of this have to do with plumbing contractors?” In short, the Atlantic Yards case provides an excellent backdrop for a discussion about liquidated damages (LD), a concept with which every type of contractor involved in a construction project should be concerned.

WHAT ARE LIQUIDATED DAMAGES?

In *Westmount Country Club v. Kameny*, the Appellate Division of the New Jersey Superior Court defined liquidated damages as “the sum a party to a contract agrees to pay if he breaks some promise, and which, having been arrived at by a good faith effort to estimate in advance the actual damage that will probably ensue from the breach, is legally recoverable as agreed damages if the breach occurs.” Such damages may not be assessed as a penalty, which has been defined as “the sum a party agrees to pay in the event of a breach, but which is fixed, not as a pre-estimate of probable actual damages, but as a punishment, the threat of which is designed to prevent the breach.” While courts around the country differ in terms of what constitutes an enforceable liquidated damages clause in a contract, courts have universally prohibited penalty provisions. In other words, while parties to a contract may provide compensation for breach of contract, they may not fix a penalty for the breach. (This is why punitive damages generally are not awarded for a breach of contract.)

According to the *Restatement (Second) of Contracts*, a scholarly treatise of black-letter law, “The enforcement of such provisions for liquidated damages saves the time of courts, juries, parties, and witnesses and reduces the expense of litigation. This is especially important if the amount in controversy is small. However, the parties to a contract are not free to provide a penalty for its breach. The central object behind the system of contractual remedies is compensatory, not punitive. Punishment of a promisor having broken his promise has no justification on either economic or other grounds, and a term providing such a penalty is unenforceable on grounds of public policy.”

HOW TO DETERMINE IF A CLAUSE IS ENFORCEABLE

For purposes of this discussion, let us hypothetically assume that a plumbing contractor called ABC has a \$100,000 subcontract with one of the prime contractors for the Atlantic Yards project. According to the subcontract, ABC is to perform plumbing work inside the Barclays Center, and like all of the trades, it has a strict schedule that is based, in part, on when the Nets are supposed to move in and start playing basketball for fans in Brooklyn. The subcontract has a clause that requires ABC to pay the prime contractor \$10,000 per day for each day after a set completion date. (Note: This is a hypothetical example. No plumbing contractor named ABC is part of the Atlantic Yards project.)

The first issue is whether the \$10,000 LD clause is enforceable as written. Since jurisdictions around the country vary in their analyses of LD claims, we will examine the *Restatement* approach, which has been adopted (with slight modifications) by many courts, including those in Alaska, Alabama, Colorado, Delaware, Oklahoma, New Jersey, and Texas. This approach involves a three-part inquiry:

The application and impact of laws can vary widely based on the specific facts involved. Nothing in this column should be considered legal advice, recommendations, or an offer to perform services. The reader should not act upon any information provided in this column, including choosing an attorney, without independent investigation or legal representation. As such, this column should not be used as a substitute for consultation with an attorney.

1. Is the liquidated amount a reasonable forecast of damages likely to be sustained due to delay in performance?
2. Is it difficult or impossible to determine actual damages likely to be sustained?
3. Was the clause intended to compensate for actual damages, or is it intended to penalize?

(For an excellent, in-depth discussion of this test, I recommend reading *Carr-Gottstein Properties v. Benedict*, decided by the Supreme Court of Alaska in 2003.)

Turning to the facts of our hypothetical, assume that the prime contractor attempted to enforce the above LD clause against ABC and sought compensation for 60 days of delay, or \$600,000. Looking at the \$10,000 per-day sum, a court would ask whether this amount is a reasonable forecast of damages likely to be sustained due to a delay. Among other things, a court would look at the facts in the beginning of this article. It would scrutinize all of the costs that would be sustained by the owner as a result of delays. While this is not a precise science, a court usually is able to get a basic idea as to how the \$10,000 per-day figure was derived. Based on the facts and circumstances, it ultimately may determine that the \$10,000 per-day sum is reasonable.

Next, the court would confirm that it is indeed difficult, if not impossible, to quantify all of the actual damages that would be sustained as a result of the delay. While some amounts, such as the transit-related costs and carrying costs, are fixed, others, such as lost Nets ticket sales and the differential in paid attendance between New Jersey-based and Brooklyn-based games, are more speculative. As the *Restatement* notes, “The greater the difficulty either of proving that loss has occurred or of establishing its amount with the requisite certainty..., the easier it is to show that the amount fixed is reasonable.”

Finally, the court would confirm that the LD clause in the parties’ contract is not intended as a penalty, and in this hypothetical case, it clearly is not. (Then again, if the per-day amount was \$150 million instead of \$10,000, with no rational basis for such a large sum, a court likely would strike the LD clause as punitive.)

DETERMINING LIABILITY

Assuming the answers to all three numbered questions above are affirmative, the LD clause is enforceable. Remember, this analysis only addresses whether or not the LD clause, as written, is enforceable against ABC. It does not examine whether the prime contractor actually is entitled to collect liquidated damages from ABC. That is the second issue.

To determine whether ABC is liable for liquidated damages, the court needs to examine each segment of the 60 days of delays to determine whether they are excusable or nonexcusable. Delays that are not attributable to ABC’s actions or inactions are excusable, and ABC should not be liable for liquidated damages as a result. If an excusable delay impacts the critical path to cause the substantial completion date of the project to slip, the contractor typically is entitled to an extension of time. Examples of excusable delays are those due to the negligence of the owner (or in this case, prime contractor), delays due to revised or changed work, unforeseen site conditions, and/or delays due to the owner’s failure to act in a timely manner. The majority of the delays discussed in the beginning of this article have nothing to do with ABC. Thus, ABC should not be liable for liquidated damages as a result of such excusable delays.

On the other hand, ABC would be liable for nonexcusable delays, such as failure to complete its scope of work on time, failure to provide the proper resources (manpower, equipment, materials), failures of its sub-subcontractors and suppliers, defective or deficient work, and/or failure to adhere to safety or environmental regulations. To the extent any nonexcusable delays occurred, ABC would be liable in the amount of \$10,000 per day of each nonexcusable delay.

Finally, delays could be concurrent. In other words, two or more delays could occur or overlap during the same period, either of which occurring alone could affect the ultimate completion date. Some of these delays may be excusable; others may be nonexcusable. Critical path method (CPM) analysis is required to apportion such delays. If the delay is apportioned, the damages against ABC may be substantiated (based on non-excusable delays), and the appropriate amount of liquidated damages may be assessed.

AVOIDING LITIGATION

Delay claims and liquidated damages can be heady stuff. The stakes often are quite high, and the outcome often turns on the interpretation of obscure construction contract provisions and jurisdiction-specific law regarding liquidated damages. This article only touches the tip of the LD iceberg in an effort to give the reader a basic introduction to a complicated topic.

Whether a party is entitled to liquidated damages is very fact specific. In addition to looking at the laws regarding liquidated damages in the relevant jurisdiction, the parties need to look at the specific language in their subcontract. Next, they need to analyze the nature and quantity of the delays to assess responsibility and examine whether a contractual extension of time is in order.

Parties that are not able to settle delay claims early face the prospect of extensive and costly litigation in which scheduling experts analyze at great length the issues of delays and CPM schedules. By learning about the ramifications and pitfalls of liquidated damages and delay claims in advance, the savvy plumbing contractor could work with his attorney to avoid costly litigation in the future. **PSD**

SUGGESTED READING

The following two leading cases and *Restatement* article on liquidated damages (referenced in this article) offer a detailed analysis of liquidated damages:

- *Carr-Gottstein Properties v. Benedict*, Alaska, 2003 (available through the Alaska Court System website: www.state.ak.us/courts/)
- *Westmount Country Club v. Kameny*, New Jersey, 1964 (available at most law libraries and on Westlaw and Lexis)
- *Restatement (Second) of Contracts* §356(1), 1981 (available at most law libraries and on Westlaw and Lexis)



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