Liquidated Damages - What are they and why have them?

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INTRODUCTION

LIQUIDATED DAMAGES ARE COMMON IN CONSTRUCTION CONTRACTS, YET THE DETAIL SURROUNDING WHAT THEY ACTUALLY MEAN, WHY THEY ARE INCLUDED AND THEIR ENFORCEABILITY CAN BE CONFUSING AND GLOSSED OVER BY THE CONTRACTING PARTIES. IN THIS ARTICLE WE EXAMINE LIQUIDATED DAMAGES CLAUSES AND THEIR IMPLICATIONS FOR CONTRACTORS IN CONSTRUCTION CONTRACTS.

WHAT ARE LIQUIDATED DAMAGES?

Liquidated damages are an amount of money that contracting parties agree on as the amount of damages one of them can recover if the party breaches the contract. The distinction between liquidated damages and general damages is that liquidated damages is a fixed rate or amount in a contract, whereas general damages is an amount determined by a court when it determines the claim.

It is usually the case that liquidated damages apply to some specific type of breach of the contract. For construction contracts, the parties will likely include a liquidated damages clause in relation to delays in completing the contracted works in case the contractor fails to meet the practical completion date.

Often, construction contracts use a formula for calculating liquidated damages which can differ from contract to contract. For instance, $1000 per day that substantial completion is late. If the main contractor is 10 days late in substantially completing their work, they owe the owner $10,000.

WHY HAVE LIQUIDATED DAMAGES CLAUSES?

Liquidation damages clauses are common in construction contracts to increase certainty, reduce the prospect of litigation, and preserve relationships, even in the face of a dispute over performance. They are also a useful mechanism for incentivising parties to complete their obligations under the contract on time.

Liquidated damages enable both parties to know up front what damages will be for the applicable breach. The principal can recover their loss without having to prove their actual loss, and the contractor will have certainty that the contract will cap their liability for damages at a certain amount.

Without a liquidated damages clause, it can be difficult for a party to prove actual damages.

FORCEABILITY OF LIQUIDATED DAMAGES

The key consideration and long-standing position in relation to case law in construction contracts is whether or not the amount specified in a liquidated damages clause amounts to a 'penalty.' If the Court finds that the clause imposes a penalty on the party in breach, the Courts in New Zealand, at present, seem unlikely to enforce the clause.

For a liquidated damages clause to be enforceable, the damages specified must represent a genuine pre-estimate of loss that the aggrieved party is likely to suffer as a result of the other party's breach. Whether a liquidated damages clause is enforceable will, of course, depend on the circumstances of each contract.

Recent decisions from the United Kingdom and Australia demonstrating vastly different approaches may be influential in the future development of liquidated damages clauses in New Zealand, particularly with regard to liquidated damages. Therefore, as always, contractors need to proceed with caution when entering into construction contracts. Make sure you know what you are signing up to.

SUMMARY

Liquidated damages clauses can be useful tools for both the principals and contractors. Each liquidated damages clause should be tailored to the specific job and drafted in a way that reflects a genuine estimate of a party's foreseeable loss directly flowing from the other party's default.

If in doubt about the terms of the contract then seek some appropriate advice from a legal representative.

FOR MORE INFORMATION
James is an experienced construction and civil litigator who has represented a wide range of clients large and small, including builders, building companies, waterproofers, roofers, window joinery suppliers, designers, engineers, homeowners and councils across New Zealand.

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