Negotiating Delay Risks: Consequential Damages, Liquidated Damages and Limitations of Liability in Construction Contracts

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Mutual Goals of Owner/Contractor

• The Goals:
  o Maximize opportunities for project success
  o **Identify project risks** and develop cost effective strategies that abate, allocate or transfer risk to the party best able to control and manage that risk
    • Contractor’s potential role much more active than in past
  o Develop clear and effective **communication and issue resolution process** to resolve problems so they do not escalate
The Risk Matrix

• Review Project Risk with the Owner
• Assist in Identifying Solutions
  o Contractual Solutions
  o Insurance
  o Contingencies
  o Process Solutions
• Develop Risk Matrix
Managing the Risk of Delay

• Delays are a common and frequently litigated project risk that can result in catastrophic loss
  o Example: Failure to complete a professional sports stadium by the opening day game

• Different risk management tools are required to address various types of delay and resulting categories of delay damage
Types of Delays, Causes and Consequences

- Three categories of delay:
  - **Excusable and Compensable Delays**:
    - Critical path delay
    - Caused by, or within the control or responsibility of the owner
    - Examples:
      - Failure to provide site access; Differing site conditions; Owner changes; Suspension of work; Inadequate plans and specifications
    - Contractor entitled to **time and money**
  - Watch out for unfair:
    - Notice Provisions
    - No Damage for Delay Clauses
    - Damage Limitation Provisions
Types of Delays, Causes and Consequences

• Three categories of delay:
  o **Excusable (but not compensable)** Delays:
    • Critical path delay
    • Beyond control of the owner and contractor
    • Examples:
      o Acts of God; Unusual weather; Industry labor disputes; Unusual material or equipment delays; Unavoidable casualties
    • Contractor entitled to **time… but not money**
  • Drafting Considerations:
    o Notice Provisions
    o Limited Compensation
    o Time extension “deductible”
Types of Delays, Causes and Consequences

• Three categories of delay:
  o **Non-Excusable** Delays:
    • Delay within control of contractor...not caused by owner
    • Examples:
      o Contractor failure to properly man project; Delay due to faulty workmanship; Subcontractor failure to perform
      o Contractor receives *neither time nor money*
      o Contractor may have exposure to owner for damages
  o Drafting Considerations:
    • Notice by Owner
    • Withholding of Payment
    • Waiver or Limitation of Consequential Damages
    • Liquidated Damages
Damages Resulting from Delay

• Two primary categories:
  o **Direct damages**: follow naturally and necessarily from the contractor’s breach and reasonably foreseeable at the time of contracting
  o **Consequential damages**: more attenuated; damages that flow from the consequences of the contractor’s actions, such as lost profits or other adverse costs or impacts to ongoing business
Delay Remedies and Risk Management Tools

• The owner’s primary tools for addressing losses that stem from delays are:
  o **Insurance** (in certain cases)
  o **Contingency funds**
  o **Contractual risk allocation** provisions, such as a **liquidated damages** clause

  o **NOTE:** These tools can protect the Contractor’s interests as well!
Owner’s Insurance

- OPPI
- Prof. Liab.
- A/E
- Additional Insured
- Owner
- Builder’s Risk
- Pollution LL
- Gen Liability
- Contractor
- WC & EL
Owner’s Delay Risk - Insurance Remedies

- **Builder’s Risk Policy** – covers losses stemming from a wide variety of risks (fire, flood, storm, earthquake, etc.) and also the **resulting delay** (if properly requested)
  - “**Expediting Expense**” coverage can cover the costs of contractors working overtime to rebuild damaged work
  - “**Contractors Extra Expense**” coverage can cover the downstream delay costs of impacted contractors
  - “**Delay in Completion**” coverage covers consequential losses if project is delayed beyond planned completion date

- **Other Policies** available for discrete loss categories including delay
Owner’s Delay Risk – Owner’s Contingency

- Owner must maintain adequate contingency for certain inherent delay risks that are not insurable or properly transferable
- Example: *Spearin* Gap Risk
  - Owner impliedly warrants adequacy of plans and specifications to contractor
  - Design professional makes no such warranty to owner: only agrees to perform to “standard of care”; i.e., not be negligent
  - If design professional is negligent, professional liability insurance may cover delay cost including consequential damages
  - If no negligence, owner contingency must respond to *Spearin* Gap losses, including costs of contractor delay
Contractor’s Delay Risk – Consequential Damages

- **Consequential damages** are often the most significant and difficult to forecast – enormous risk potential
  - Example: Perini Corp. v. Great Bay Hotel & Casino, Inc.
    - Contractor hit with $14,500,000 judgment for consequential damages - 25x its Fee!!
- After Perini, the Mutual Waiver of CDs clause first appeared in AIA General Conditions (1997)
- Most owners can’t absorb the risk of a complete CD Waiver for contractor caused (i.e., non-excusable) delay – precludes recovery of lost profit, use, income, etc.
- **Liquidated damages clauses** are the best tool to balance and fairly allocate such risks
Liquidated Damages

• Converts owner’s anticipated damages for delay to a predetermined and fixed amount
• Legal rules of enforceability –
  o **Intent**: must be to compensate for actual (but difficult to forecast) loss, not to punish or penalize for breach (against public policy)
  o **Reasonableness**: must be a reasonable estimate of anticipated actual damages
  o **Uncertainty**: the actual damages covered must be difficult to forecast or prove
Liquidated Damages – The Reasonableness Test

• **Reasonableness:**
  
  o **Majority rule**: reasonableness of the estimate of LDs is assessed at the time of contracting (Prospective Rule)
  
  o **Minority rule**: reasonableness of estimate may be determined by comparing to damages actually sustained to determine if the compensation is just (Retroactive Rule)
Liquidated Damages – Other Legal Considerations

• **Sole and Exclusive Remedy**
  o Owner cannot recover actual damages in excess of LDs
  o However, if the clause is found invalid, actual damages may still be pursued

• **Default or Abandonment**
  o If contractor is terminated prior to substantial completion, owner can recover LDs if (1) acts reasonably in re-procuring work and (2) expressly reserves the right to such damages in the LDs clause

• **Concurrent Delays**
  o Not recoverable if the fault of parties is “inextricably intertwined”
  o May be recoverable if fault can be apportioned, depending on jurisdiction

• **Burden of Proof**
  o LDs are presumed enforceable – burden is on party seeking to invalidate the clause
Liquidated Damages – Tips on Assessment and Negotiation

• (1) Mutual Evaluation of the Owner’s Potential Loss
  o Lost net revenue, expenses for alternate facility, extended design and project management fees, advertising expense, etc.

• (2) Mutual Evaluation of Impact of LDs on Market
  o Unreasonably high LDs will impact contract price (especially flow down pricing from subs) and/or dissuade bidders
  o Contractor’s risk appetite for LDs depends on project type, project delivery method, fee and ability to use contractor’s contingency to absorb delay risk (by paying acceleration costs)

• (3) Evaluate Practical LD Limitations
  o For large projects using open book pricing, LDs are typically capped at 50-100% of contractor’s total fee (profit + home office overhead)
The Liquidated Damages Clause – Drafting Considerations

- Recitals of the basic principles of enforcement are helpful
  - (1) Reasonableness of the estimate
  - (2) Difficulty of predicting precise actual damages
  - (3) Intention to compensate, rather than penalize
  - (4) Sole and exclusive remedy
  - (5) Assessment of damages at time of contracting
- However, there is no “magic” language – courts will look beyond boilerplate recitals
- Detailed explanations pegged to specific milestones, along with evidence for calculations, will help establish an enforceable clause
Interplay of Liquidated Damages, Fee and Construction Contingency

- Contractor’s contingency is an important risk management tool
  - For open book, Guaranteed Maximum Price projects – Contractor’s contingency is used to cover certain costs within contractor’s control and responsibility

- Negotiation of the LDs clause is linked to:
  - Contractor’s Fee
  - Contractor’s Contingency (including shared savings or incentives)
  - LD cap

- Issue: Can the contractor use contingency to cover LDs?
  - Use for delay avoidance vs. damage assessment
Caps on Liquidated Damages

• Useful tool for incorporating the assessment of market conditions
• But... what is the contractor’s incentive for finishing work when LD cap is reached?
  o Availability of cap must be premised upon contractor’s obligation to diligently pursue the work in good faith, even if cap is reached
Liquidated Damages and Waiver of Consequential Damages

- Important to coordinate the drafting of both provisions
- Include carve out language in the CD Waiver Clause to protect the owner's right to recover the negotiated amount of LDs, while providing the contractor with other CD Waiver protection
Sample CD Waiver

This mutual waiver includes:

1.1.1.1. damages incurred by Owner for rental expenses, for losses of use, income, profit, financing, business and reputation, and for loss of management or employee productivity or of the services of such persons; and

1.1.1.2. damages incurred by Contractor for principal office expenses including the compensation of personnel stationed there, for losses of financing, business and reputation, and for loss of profit except anticipated profit arising directly from the Work and earned by Contractor in accordance with the Contract Documents.

Nothing in this Section shall preclude any recovery of the following:

1.1.1.3. liquidated damages due under the Contract Documents;
1.1.1.4. third-party claims for personal injury or property damage;
1.1.1.5. claims or damages relating to violations of Applicable Law;
1.1.1.6. claims or damages relating to fraud, negligence, willful misconduct;
1.1.1.7. claims or damages covered by insurance; or
1.1.1.8. claims, damages, costs or expenses caused by Contractor’s refusal to perform under the Contract Documents, including, Contractor’s refusal to perform any express warranty under the Contract Documents.
Liquidated Damages and Performance Bonds

• Whether LDs or CDs are recoverable under a performance bond depends on the language of the bond and the law of the applicable jurisdiction.
• Recovery typically limited to penal amount of bond—i.e., 100% of contract value.
• The bond must either incorporate the LD provision or expressly permit the recovery of LDs.
Conclusion

• The effective use of a commercially reasonable liquidated damages clause is a particularly effective risk management device that can optimally balance the interests of both the owner and the contractor with respect to contractor-caused delay

• Careful drafting and negotiation is required to create an effective and enforceable clause
Questions