

Understanding Liquidated Damages in Construction

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Delays in the construction business are common for construction projects. For some projects, excessive setbacks can have a ripple effect downstream, such as increased project costs, incidental damages, missed business opportunities, or a late start for other dependent activities. Sometimes these delays are unavoidable. Other times, they may be due to the contractor's oversight. In these instances, delays to the substantial completion date could be determined to be a breach of contract. This is where liquidated damages come in. Although no one wants to be in a situation to have to deal with them, it's important to understand what they are, how they are calculated, and what you can do to mitigate their occurrence in the first place.

WHAT IS THE LAW OF LIQUIDATED DAMAGES IN CONSTRUCTION

According to Cornell Law School, liquidated damages include a variety of actual damages, but they usually appear in a contract as a clause or section. Broadly, parties to a contract use liquidated damages when actual damages are hard to prove.

Suburban Magnesium Foundry, Inc. states, "a provision for liquidated damages will be regarded as valid, and not a penalty when three conditions are met: (1) the damages to be anticipated from the breach are uncertain in amount or difficult to prove, (2) there was an intent by the parties to liquidate them in advance, and (3) the amount stipulated is a reasonable one, not greatly disproportionate to the presumable loss or injury."



In construction, the liquidated amount of damages is the agreed-upon compensation owed to one party (most often the client) when the other party (often the contractor) doesn't meet the timeline requirements. Liquidated damages are based on a forecast of estimated real costs and losses the first party would likely incur. This is set forth in a liquidated damages clause within the construction contract before the project begins.

QUALIFYING FACTORS FOR LIQUIDATED DAMAGES

For an owner to qualify for liquidated damages, some legal and process requirements must be met. Liquidated damages are established to compensate for losses resulting from a delay in a project's substantial completion date. Liquidated damages are not meant to punish the contractor and cannot be used as a coercive measure.

Before a liquidated damages clause can be enacted, both parties must agree upon the daily cost of delays. Once the project is substantially complete, the liquidated amount stops accruing.

THE BENEFITS OF A LIQUIDATED DAMAGES CLAUSE

Why is a liquidated damages clause in the contract? Because a liquidated damages clause provides security and predictability to construction projects. It's a great way to hold contractors accountable without penalizing them and helps to ensure your project is substantially completed on time without incidental damages. Setting an agreed-upon amount in damages gives both parties an opportunity to settle on a reasonable amount.

If the liquidated damages clause is breached, the owner can determine the damages without the long and costly process of proving actual damages. In this way, it acts as a form of insurance for the owner. Contractors can use the liquidated damages clause to calculate the risk involved in delaying a project and may limit the damage claims from the owner.

The main benefits of a liquidated damages clause include:

- » Increased security and assurance for the owner that every effort will be made to complete the project on time
- » Reduced risk for contractors breaching the contract by negotiating for realistic timelines, especially when backed by historical benchmarks
- » Preferable over a lengthy and costly litigation process to calculate actual damages

There is no one-size-fits-all way to calculate liquidated damages in construction since no two projects are identical. That means project delays have different costs for different projects.

WHAT ARE THE MAJOR CAUSES OF LIQUIDATED DAMAGE?

Some of the factors that may influence the liquidated damages costs include:

- » Loss of revenue
- » Storage costs
- » Rental costs
- » Equipment costs
- » Supply chain disruptions

These damages costs are deducted from the contractor's project price, which could affect their return on investment. To help head off the potential of litigating a dispute in court, both sides arrive at a mutually agreeable set of terms when the damages clause is being written up before the project even starts, and both assign acceptable levels of responsibility.

AVOIDING OR REDUCING THEIR IMPACT

By taking steps to reduce their occurrence altogether or to at least mitigate their degree of severity, you can create a proactive risk-avoidance blueprint that aims to better preserve your ROI and your peace of mind.

There is comprehensive estimating software that can help take the guesswork out of your project bids and ongoing estimates with real-world forecasting scenario capabilities that provide insights into a true picture of your progress.

And that comes in handy when those clauses are first being drawn up. You'll not only gain the level of control you need to head off costly mistakes that could lead to a liquidated damages claim needing to be filed, but you'll also gain greater certainty that the project can be constructed within the established budget and timeline.

Nobody wants a situation that could trigger liquidated damages to claim to begin with. That's where the second way to mitigate this risk comes in. It's through using construction technology. There are several different kinds of software – each designed to carry out specific business functions – that can give you more insight into and control over a range of factors that can help prevent damage claims.

ESTIMATING SOFTWARE ESTABLISHES REALISTIC SCHEDULES ON WHICH TO BASE LIQUIDATED DAMAGES

Because contract liquidated damages negotiations occur during the estimating stage, estimating software is going to have a direct impact on how those conversations roll out. Its ability to automate the process of determining reality-based timelines, especially when backed by the historical project data it stores, can serve as validation when those talks begin.

Take a look at that past data, with extra attention paid to your schedule performance index (SPI) metrics. How well did schedules align with the projects' original estimates? How

often and for how long did any notable fluctuations occur? What impacted the schedule that you had no control over? Are the causes of these fluctuations – both within and out of your control – likely to surface during this project? How well did contingency plans keep the projects on track?

The timelines you set for the current project will depend on the answers to these questions and can be used to set schedules based on realism rather than on ambitious expectations.

CONNECTED ANALYTICS SOFTWARE TRACKS REAL-TIME SCHEDULE METRICS

Contractors are turning to metrics that track project performance in real-time, like earned value management (EVM) (which includes SPI), to help them keep a constant tab on their projects. The most effective way to monitor them is through connected analytics software. Because these metrics are sensitive to internal and external risk factors as they occur, the software can call attention to portions of the schedule that are showing signs of skewing off course. Alerting you, this heads-up about a schedule-impacting situation gives you some lead time to determine the cause and ways to course-correct before it worsens and becomes a contract liquidated damages claim.

FORECASTING CAPABILITIES PROMOTE A PROACTIVE APPROACH TO PREVENT LIQUIDATED DAMAGES

Though both the owner and contractor assume some level of responsibility as agreed upon in a liquidated damages clause, it's common for the clause to be invoked when there's an unintended oversight on the contractor's part. So how can a contractor keep from being on the receiving end? By taking a proactive approach to prevent it from happening in the beginning.

When used as a planning tool, software with forecasting capabilities takes on this preventive role, tapping into past project data to determine likely what-if scenarios and then predicting their potential impact on the current project's construction schedule. Even real-time, unexpected events and necessary change orders benefit from this forecasting.

What makes this technology so well-suited for averting liquidated damages situations is its ability to suggest

contingency plans that help you navigate through risks, so the project schedule endures the least amount of impact.

It puts more insight and control in the hands of the contractor to proactively reduce the likelihood of any damages claims.

REPORTING SOFTWARE PROVIDES VISIBILITY INTO PROJECT PROGRESS AND DELAYS

One effective way contractors can ensure owners don't hold them accountable for unavoidable delays is to share access to digital daily reports available through reporting software. This regular communication tool keeps them in the know about their project's progress. Owners can see how their requirements are being met and the efforts undertaken to keep the project on schedule.

This transparency can keep contractors from being held responsible for project slowdowns or disruptions beyond their control. That's one of the benefits of reporting software: reports serve as documented proof of all circumstances that occurred on the project, what was done to mitigate them, and the end result – and may be used to defend against any contract liquidated damages claims.

DOCUMENTATION SOFTWARE STREAMLINES THE PUNCH LIST PROCESS

Believe it or not, punch lists can be an efficient tool to reduce contract liquidated damages claims. But there are a couple of catches: First, they must be implemented at the beginning of a project, not during the traditional project completion phase. Known as rolling punch lists, they're completed throughout the construction period. As issues are found, they're documented and resolved.

And second, they should be digital. Cloud-based documentation software allows contractors to use templates – standard or customized – for these rolling punch lists. These templates are accessible out on the job site via a mobile device, making it faster and more efficient to catch errors and defects that could otherwise have turned into a painfully long to-do list resulting in costly rework. And that rework is one of those late-stage activities that can jeopardize the on-time completion of the project, and potentially trigger the liquidated damages clause.

COMMISSIONING SOFTWARE FOSTERS ONGOING SYSTEMS EVALUATION

Commissioning has traditionally been the last activity to complete just before handover. But like rolling punch lists, cloud-based commissioning software, when launched as construction begins, streamlines this system-evaluation process.

Capital projects often have overlapping phases of construction with multiple systems being installed within each. By relying on software accessible on a mobile device and moving the process up to the start of the project, it's possible to do regular documenting and testing much more quickly, accurately, and efficiently. Logging any defects and malfunctions throughout construction keeps them from becoming full-on repair work that jeopardizes timely project completion – and risks liquidated damages claims.

REDUCING THE RISK OF CONTRACT LIQUIDATED DAMAGES WITH CONSTRUCTION TECHNOLOGY

Each type of software in its own way contributes to keeping the damages clause from being invoked. Individually and combined, they offer far more control over the processes and workflows that otherwise might be headed for damage claims. 



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