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**A New Approach to Liquidated Damages: Looking Back Towards  
Reasonableness**

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*No harm, no foul.* Although this well-known phrase originated on the basketball court, its message was most recently challenged on the baseball diamond. In 2008, the owners of the Washington Nationals, the Major League Baseball franchise in the District of Columbia, sought at least \$100,000 per day from the local government pursuant to a liquidated damages provision because the new stadium allegedly was not “substantially complete” by the construction contract's deadline.<sup>1</sup> The owners demanded these damages—*after* the ballpark had hosted at least 50 baseball games—because several “punch-list” items from the contract remained incomplete.<sup>2</sup> In construction contracting, liquidated damages provisions are commonplace. Indeed, today, construction-project owners are likely to demand the inclusion of a liquidated damages clause to define the scope and extent of damages in the event of a delay or breach. Moreover, such clauses are often championed as a means to avoid costly later litigation in instances where monetary damages cannot be easily ascertained or calculated.

The case of Nationals Park, however, highlights a fundamental inconsistency in the prevailing law governing the enforcement of liquidated damages provisions. Indeed, the prevailing confusion in the case law threatens the clauses' primary justification—cost and time efficiency. The well-established case law dictates that a liquidated damages provision will not be enforceable if it is classified as a “penalty.”<sup>3</sup> The determining factors in deciding if such a provision is an unenforceable penalty are (1) whether damages were difficult to ascertain, and (2) whether the liquidated damages clause was a reasonable pre-estimate of the damages.<sup>4</sup> In many states, however, this “reasonableness” analysis is judged at the point in time when the contract was signed—the very time when damages had to be difficult to determine—without any

reference to the actual damages suffered. Therefore, even when a delay does not affect the revenue-producing function of a facility, a construction owner may still be entitled to the entire amount in his liquidated damages provision. Tellingly, if the Washington Nationals had pursued their case against the District's local government and succeeded, the owners would have received approximately \$100,000 per day in damages for a stadium project where all the revenue-generating events took place on time.

As shown below, the traditional law governing liquidated damages often protects the contracting parties' freedom of contract at all costs, including intuitively unjust windfalls. Courts take a "single look" at the contract's liquidated damages provision, regardless of the actual damages accrued by the delay. This paper and the attached article, *The Reasonableness of Liquidated Damages Provisions-Why Only the Look Back Approach Can Prevent Windfalls*, propose an alternative method to the current approach governing liquidated damages.<sup>5</sup> Pursuant to this proposed "look back" approach, in limited circumstances, courts could assess the reasonableness of the liquidated sum against the actual damages suffered due to a delay. This hybrid approach seeks to prevent windfalls while maintaining the integrity of reasonable, bargained-for exchanges. The following sections provide a brief introduction to liquidated damages provisions, as well as an overview of the shortcomings in the current approach to enforceability and the proposed alternative. The attached article dives deeper, providing an in-depth analysis of the current case law and a detailed explanation of the authors' suggested solution.

## **I. A Brief Summary of Liquidated Damages**

### *A. Traditional Liquidated Damages*

Under traditional contract law, penalty clauses that seek to compel performance typically are per se unenforceable. Due to their similarity to such penalty clauses, liquidated damages provisions were historically disfavored by courts.<sup>6</sup> Over time, however, liquidated damages clauses were included in construction contracts in an attempt to prevent costly and time-consuming litigation to determine damages in the event of a later breach or delay in the project.<sup>7</sup> Today, liquidated damages provisions are commonplace features within construction contracts. Rather than punish the breaching party, a liquidated damages provision should provide fair and adequate compensation to the aggrieved party.<sup>8</sup> Indeed, a well-drafted liquidated damages provision presents the parties with the economic risks of delay from the start of their project.

A standard liquidated damages provision usually will dictate a daily rate of damages to be paid by the contractor in the event that the project is not substantially completed by the completion date. Upon substantial completion, the liquidated damages provision will terminate. As a result, the definition of “substantial completion” becomes critical in any construction-delay dispute. At common law, substantial completion occurs when the owner is able to use the project for the purpose intended.<sup>9</sup> In many modern contracts, however, substantial completion will be defined by the parties. Furthermore, as seen in the Washington Nationals dispute, the contractual definition of substantial completion could include action items far beyond those needed to render the project capable of being used for its intended purpose, i.e., submission of all maintenance manuals or a close out of punch-list items. Thus, the contractual version of substantial completion may be delayed, even where a construction-owner is capable of carrying out all revenue-producing activities at the facility. These precise instances highlight the shortcomings of the traditional approach to enforcing liquidated damages provisions discussed below (*supra* Section II.).

### *B. Reverse Liquidated Damages*

In contrast to a traditional liquidated damages provision, reverse liquidated damages clauses provide for damages in favor of the contractor where the construction owner is the cause of delay. These reverse provisions can provide similar benefits to traditional clauses and present the owner with the economic risks of delay up front. Furthermore, reverse provisions may balance a liquidated damages clause that favors the owner, allow for faster resolution of delay disputes, and eliminate costly legal battles over enforceability. Notwithstanding these benefits, reverse liquidated damages clauses appear far less often than traditional liquidated damages provisions.<sup>10</sup> In fact, owners will typically attempt to limit their exposure for delay by including “no damages for delay” clauses in their construction contracts.<sup>11</sup>

Despite the prevalence of “no damages for delay” clauses, contractors may still attempt to balance the economic risks of delay by including a reverse liquidated damages provision. Indeed, some states have attempted to minimize the reach of the “no damages for delay” clause by prohibiting its enforceability with respect to certain types of delay.<sup>12</sup> Pursuant to California Public Construction Code §7102, “[c]ontract provisions in construction contracts of public agencies . . . which limit the contractee's liability to an extension of time for delay for which the contractee is responsible and . . . is unreasonable under the circumstances involved, and not within the contemplation of the parties, shall not be construed to preclude the recovery of damages by the contractor.” By authorizing damages for specific kinds of delays, the California code allows contractor’s to seek a reverse liquidated damages clause. For example, one California public works contract has contained the following reverse liquidated damages provision:

Reverse Liquidated Damages: In anticipation of, and in compliance with, the provisions of California Public Contract Code § 7102 and because it is agreed by the contractor and the owner that actual damages are impracticable and extremely difficult to ascertain, if the contractor is delayed in completing the work due solely to the fault of the owner, and where such delay is unreasonable under the circumstances and not contemplated by the parties, the contractor shall be entitled to the appropriate time extension and to payment of liquidated damages in the amount per day of \$ \_\_\_\_\_. The contractor expressly agrees to be limited solely to these liquidated damages for all such delays as defined in this subsection.<sup>13</sup>

This reverse provision would allow for liquidated damages in favor of the contractor where the owner's delay was unreasonable under the circumstances or unforeseen. Nonetheless, because such reverse liquidated damages clauses are uncommon, both owners and contractors may be hesitant to include them in construction contracts. Moreover, the law governing the enforceability of liquidated damages provisions, in general, threatens to undermine the effectiveness of both traditional and reverse liquidated damages provisions.<sup>14</sup> This legal dilemma is the subject of the attached article and is briefly summarized hereto.

## **II. The Current Problem with Enforcing Liquidated Damages Provisions**

Although liquidated damages provisions have become fairly ubiquitous in construction contracting, there are limits to their enforceability. A liquidated damages provision will not be enforced if it constitutes an improper penalty. To determine whether a particular clause constitutes an improper penalty, courts traditionally employed a two-prong test: for a liquidated damages provision to be enforceable, (1) the damages must be difficult or impossible to ascertain with certainty; and (2) the amount of liquidated damages must be reasonable with respect to any anticipated harm.<sup>15</sup> In the case of construction delays, damages are “nearly always difficult to determine,” such that the crux of the damages dispute becomes whether the liquidated sum constitutes a reasonable estimate of the relevant party's foreseeable damages.<sup>16</sup> Courts, however,

are divided over the time at which this reasonableness analysis should occur. A larger number of states have adopted a prospective approach, or the “single look” method: the liquidated sum must have been reasonable only at the time of contract formation.<sup>17</sup> An alternative model is the so-called retrospective approach or “second look” method. This approach, adopted by the Restatement Second of Contracts and the Uniform Commercial Code, allows the court to judge the reasonableness of the contract’s liquidated sum against the actual damages stemming from the delay.<sup>18</sup>

Proponents of the traditional, single look method argue that this approach protects the freedom of contract and prevents courts from rewriting the parties’ negotiated terms.<sup>19</sup> Moreover, promoters of this model reason that a prospective approach promotes efficiency and avoids costly litigation battles over actual damages.<sup>20</sup> The single look method, however, can be overly rigid and often creates manifest unfairness, particularly in cases where the construction project can be used for its intended purpose but the contractual definition of “substantial completion” has not been met. In such a case under the single look method, a party may receive the total liquidated sum when substantial completion is delayed, even if that party has not accrued significant damages. It is difficult to understand how such an economic windfall should not be considered a “penalty” against the losing party.

To prevent such windfalls and to offset the potential shortfalls of the single look approach, the attached articles proposes a modified retrospective approach or a “look back” method.

### **III. The Proposed Solution: The Look Back Method**

In cases where the construction owner has taken occupancy of the facility without impairment of the owner's ability to use the property for its intended purpose, West and Hissam propose that courts take a “look back” to actual damages before granting an award.<sup>21</sup> Pursuant to the look back approach, courts would adopt a “triggering mechanism” whereby the fact-finder first would assess the scope of the actual damages incurred and how they compare to the liquidated damages amount. If the facility can still be used for all or nearly all of its intended revenue production *and* liquidated sum bears no “reasonable relationship” to the actual damages alleged by the plaintiff, then a full “look back” is necessary. If the fact-finder then determines that no actual damages were incurred (or the amount of those damages is minimal), then the liquidated damages provision should be deemed an unenforceable penalty.

The look back method attempts to bring liquidated damages provisions more in line with the compensatory, rather than punitive, theory of contracts. Although single look proponents argue that a prospective approach protects the freedom of contract, a windfall that is unreasonably detached from actual, compensatory damages undermines the very notion of bargained-for exchanges. Moreover, West and Hissam warn that fact-finders adopting the look back method should be mindful not to rewrite the parties’ terms, and they temper this risk by requiring a *prima facie* showing that a look back is necessary given the circumstances.<sup>22</sup> By allowing a “look back” in the defined circumstances, this proposed solution not only prevents windfalls but also allows courts to more accurately determine whether the liquidated damages provision is an improper penalty. By considering the amount of actual damages, courts can better evaluate whether the liquidated sum is a reasonable pre-estimate of the damages.

In addition, the look back approach can be modified to account for reverse liquidated damages provisions. In a typical build, contractors will face a wide range of potential costs in



the event of the construction-owner's delay, and these costs will vary widely based on the circumstances of the case.<sup>23</sup> Therefore, the single look method may pose particular difficulties in reverse liquidated damages cases—either creating a vast discrepancy between the liquidated sum and the actual damages or perhaps discouraging the parties from entering into the reverse clause in the first instance. In contrast, under the proposed look back method, the contractor would be precluded from receiving an economic windfall that would penalize the owner in the event of delay. If the triggering conditions—which would need to be adapted to the unique circumstances of each case—were satisfied, then the court could review the contractor's actual costs as compared to the liquidated sum. The reverse liquidated damages clause would be unenforceable when it departed too significantly from the contractor's actual damages.

The attached article provides a more in-depth review of the controlling case law regarding the enforcement of liquidated damages provisions and uses a unique hypothetical to illustrate the benefits of the look back solution. Upon review of the single look and second look methods for enforcing liquidated damages provisions, the proposed look back hybrid presents the fairest and most accurate approach to calculating a liquidated damages award. Rather than blindly upholding the parties' freedom of contract, the look back method seeks to maintain parties' bargained-for exchanges while eliminating economic windfalls to the enforcing party. In doing so, the look back method reemphasizes the long-held notion that contract-damages awards should be compensatory and prevent unjust penalties.

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<sup>1</sup> LeDuc and Nakamura, Nationals Withhold Rent on Ballpark, Wash. Post, July 11, 2008, at B1.

<sup>2</sup> *Id.*

<sup>3</sup> 2 Joseph M. Perillo, Corbin on Contracts § 58.5 (Rev. ed. 2005) [hereinafter Corbin on Contracts].

<sup>4</sup> *Id.*

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<sup>5</sup> Joseph D. West and Michael B. Hissam, *The Reasonableness of Liquidated Damages Provisions-Why Only the Look Back Approach Can Prevent Windfalls*, 4 J. AM. C. CONSTR. L. 1 (2010).

<sup>6</sup> *Id.* at n.18.

<sup>7</sup> *Id.* at 2, n.4.

<sup>8</sup> *Priebe & Sons, Inc. v. United States*, 332 U.S. 407, 411 (1947)

<sup>9</sup> *G & C Enterprises, Inc. v. United States*, 55 Fed. Cl. 424, 427 (2003); West and Hissam, at n.13.

<sup>10</sup> Daniel D. McMillan, *Balancing the Liquidated Damages Equation: Reverse Liquidated Damages in Favor of the Contractor*, Construction Law SuperConference (2001), *available at* [http://www.jonesday.com/\\_lawyers/bio.aspx?attorneyID=8b253eb1-c40a-4bf9-986c-8d8255000af9&section=Publications](http://www.jonesday.com/_lawyers/bio.aspx?attorneyID=8b253eb1-c40a-4bf9-986c-8d8255000af9&section=Publications)

<sup>11</sup> Robert Frank Cushman, *et al.*, *Construction Disputes: Representing the Contractor* 138 (2001).

<sup>12</sup> *Id.*

<sup>13</sup> McMillan, *Balancing the Liquidated Damages Equation*, at 4.

<sup>14</sup> *See supra* Section III.

<sup>15</sup> Restatement (Second) of Contracts § 356 (1981); U.C.C. § 2-718 (1977).

<sup>16</sup> 2 Corbin on Contracts § 58.21.

<sup>17</sup> *See* West and Hissam, at 10-11. General federal law of contract also adopts the single look approach. *See K-Con Building Sys., Inc. v. United States*, 97 Fed. Cl. 41, 50 (2011) (“When presented with a challenge to a liquidated damages clause, a court must judge the clause as of the time of making the contract and without regard to the amount of damages, if any, actually incurred by the nonbreaching party”) (internal citation omitted).

<sup>18</sup> Restatement Second, Contracts § 356(1); U.C.C. § 2-718(1); *see also Gateway Towne Centre, LLC v. First United Bank & Trust*, 2011 WL 3877010 (N.D.W. Va. Sept. 2, 2011).

<sup>19</sup> *See* West and Hissam, at 10-11.

<sup>20</sup> *Id.* at 11.

<sup>21</sup> *Id.* at 13-20.

<sup>22</sup> *Id.* at 17.

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<sup>23</sup> Robert Frank Cushman, *et al.*, *Construction Disputes: Representing the Contractor* 137 (2001).