

## Liquidated damages in construction contracts

The inclusion of a liquidated damages clause in construction contracts is a common way of addressing what sanctions will apply if a breach of contract arises during the operation of the contract and particularly when a contract and a build is ongoing.

It is therefore important to understand exactly what is meant by this term, particularly if you find yourself in the unfortunate position of being the party in breach under the contract.

### **What are liquidated damages?**

In their simplest form liquidated damages are a way of calculating what compensation a party in breach of its obligations under a contract will pay to another party to that contract.

As the exact amount of damages for a breach of contract can often be difficult to calculate at any given moment, rather than a contract providing for an unquantified amount of damages, a liquidated damages clause fixes the sum of any damages in advance and includes details of the sum to be paid should a breach occur in the contract.

### **Are liquidated damages the same as agreed damages?**

The short answer is 'yes'. Other terms you may come across, which effectively mean the same thing as 'liquidated damages' include 'pre-estimated damages', 'stipulated damages', 'liquidated and ascertained damages' and 'adjustment of time costs'.

### **Liquidated damages clauses in construction contracts?**

Liquidated damages clauses are useful in construction and other commercial contracts because they provide a degree of certainty for all parties as to what will happen should a breach of contract occur.

It can sometimes be difficult to quantify the extent of any damage suffered when a build is ongoing. However, the inclusion of a liquidated damages clause in a contract does away with the need to prove the quantum of any actual loss and allows both parties to decide in advance exactly what their respective rights and liabilities will be in the event that a breach of contract occurs.

Liquidated damages clauses are particularly relevant for construction contracts because they:

- Allow the parties to quantify and be clear about risk allocation and their intentions should a breach of contract arise and also allow parties to clearly understand in advance how loss will be calculated should a breach occur;
- Encourage all parties to comply with their respective contractual obligations in the knowledge that if a breach occurs the clause can be enforced without the need to resort to litigation;
- Allow a contractor, at the time they are tendering, to factor the price of their exposure (the amount specified for liquidated damages if there is a breach) into their contract price;
- Allow a contractor to compare the cost of accelerating works in order to achieve practical completion by a required date versus the amount of any liquidated damages sum that becomes due and payable if the date for practical completion is not achieved;
- Provide a ceiling or cap on a contractor's liability for damages for specified breaches of contract; and
- Provide a principal with a means to recover damages regardless of the amount of any actual loss.

### **Liquidated damages vs. penalty clauses?**

While the courts have demonstrated on multiple occasions that they will enforce liquidated damages clauses they have also made it clear that they will not enforce a clause if it amounts to a penalty.

The factors that determine whether a liquidated damages clause is a de facto penalty clause will vary from build to build and contract to contract. However, the courts have traditionally applied four key tests when considering whether a contractual provision goes beyond liquidated damages and is in fact a penalty.

The first three key questions to consider are:

- Is the amount provided for in the clause “extravagant and unconscionable” when compared with the greatest possible loss that could possibly be shown to result from the particular breach of contract?
- Does the breach consist solely of non-payment of money which results in a larger sum for damages being required?
- Does the clause stipulate the same amount of damages for different breaches even if the breaches vary in terms of seriousness?

If the answer to any of these questions is ‘yes’ then it is likely the clause will be considered to be a penalty and will not be enforceable.

**What if actual loss can't be quantified? Is it a penalty?**

The courts have indicated that they will not consider a clause to be a penalty simply because it is not possible to estimate in advance the actual or true loss that may be suffered. Therefore it is important to consider the previous tests carefully when determining the size and scope of any liquidated damages clauses.

The difference between a fair and reasonable liquidated damages clause and a clause that may be struck down by a court as being a penalty and unenforceable, can be a difficult line to draw, even when all parties to a contract enter into negotiations with the best of intentions.

Before entering into a contract or agreeing to a liquidated damages clause it is always advisable to seek legal advice to ensure that you understand the full ramifications of the agreement and to check that, if needed, the terms of the contract will be able to be enforced either for or against you.

If you or someone you know wants more information or needs help or advice, please contact us on 1800 888 783 or email [doyles@doylesconstructionlawyers.com](mailto:doyles@doylesconstructionlawyers.com).