Between the Lines

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Insights From a Career Claims Professional

What is the Problem with Agreeing to Liquidated Damages?

It is commonplace for a liquidated damages clause to be contained in an Owner/Contractor agreement. This makes sense because the completion date is generally significant to an owner, and the contractor has submitted a price for their work and has agreed in their contract to a completion date. By the time the contractor is awarded the contract, they usually have the contract documents, and they have used them to price the job and complete a construction schedule. Once a notice to proceed is issued to the contractor, the contractor controls the schedule.

Liquidated damages clauses in construction contracts came about because actual damages are difficult to establish in the case of a delay. To avoid this, the owner and contractor agree to a reasonable daily number that will act as a substitute for the actual damages. These will generally be assessed against the contractor for every day or business day the project is late. Delay damages are also costly both to prosecute and to defend. The number established in the contract must relate to what actual damages might be. If the number selected is excessive, a court may decide the clause is not enforceable. Generally, however, liquidated damages are the exclusive remedy if the project is late.

It is becoming more frequent that owners, or their lawyers, try to assert liquidated damages into design contracts. Liquidated damages are not covered under a professional liability policy. Sometimes the clauses are related to design completion dates. There are a lot of factors that can contribute to delays in the completion of design documents, including consultants and owner's consultants' timely completion of work, permit reviews and comments, and redesign by owners which they may see has minor but have impacts they may not see. As recent experiences with the pandemic illustrate, there are many intangibles. Furthermore, there are generally low actual damages associated with design delay, as a notice to proceed the construction has not been issued, and there has been no construction priced or schedules. Therefore, the potential exists that the actual damages will be less than the number in the contract.

Other times these provisions relate to all aspects of the contract, including the construction completion date.

Even though the design professional has no responsibility for construction and no control over the schedule, there are time-related aspects of a design professionals' performance during contract administration. For example, those regarding submittal review turn around, RFI responses, change order review, and review of the payment certifications, admittedly, if these are consistently not met, can affect the contractor. My experience is that they are generally not a valid cause of delay.

Suppose a contractor claims that the design professional failed to meet these time aspects of the contract and delayed construction. In that case, nothing precludes the owner from making a negligence claim against the design firm, which may pass on the contractor's claim in that regard. Without a liquidated damages clause, this type of claim should not result in serious coverage issues if there is a breach of the standard of care alleged. Professional Liability coverage is tied to negligence, and claims are paid when it is established that there are breaches of the standard of care and damages that result from that breach.

Most professional liability policies specifically exclude liquidated damage claims, as they are not available to the owner unless they are in the contract. Even if there is no specific liquidated damages exclusion, the contractual liability exclusion will apply, so coverage remains a serious issue.

The only time a design firm's obligation to pay liquidated damages might fall under their professional liability coverage is if it can be established there were actual and measurable damages to the client caused by a delay attributable to the firm's negligence in providing professional services. This would require the owner to allege negligence and prove damages, something they have tried to avoid by inserting the liquidated damages clause. There are times, depending on the language in the policy even this could be a problem. This is not a fight you want to have. It's stressful enough to have a claim made, and a potentially uncovered claim may keep you up nights.

Rather than face potentially serious coverage implications because of a liquidated damages clause in a contract, go into contract negotiations with enough ammunition to explain why they are appropriate for contractors but not for design professionals.

Arguments to be made include the different nature of the responsibilities in the contract, the preparation, and control of the schedule, and can even include different sizes of the contracts. Explain to the client that a liquidated damages provision is an uninsurable obligation and that taking on uninsured risk is not contemplated in establishing design fees. Remind the client that they require professional liability coverage so that there will be coverage if there is negligent performance. It is not in the owner's interest to require things in a contract that will not be covered by a policy they require.

You might want to head into contract negotiations ready to suggest a replacement clause that recognizes the client's milestone expectations and ties meeting those milestones to the standard of care. The clause can indicate that services will be performed as expeditiously as is consistent with professional skill and care and the orderly progress of the project.

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About the Author: Lauren Rhodes Martin is risk management and claims specialist focusing on the firm's architect and engineer accounts. In her role, Lauren, who is based in the Ames & Gough Washington, DC office, works directly with the firm's partners and client executives on all aspects of design firm clients' risk management, including contract reviews, claims advocacy, loss prevention training and advice. Prior to joining Ames & Gough, Lauren had a distinguished career of nearly 35 years at CNA, where she held positions of increasing responsibility in claims and client management, culminating with her appointment in 2018 as A/E Platinum Accounts Director. For more than three decades she was directly responsible for handling architect and engineer errors and omissions (E&O) claims.