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Is Your Liquidated Damages Clause Valid?

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Should you include a liquidated damages provision in your contract? If you have such a clause in your contract, and completion of the project has been delayed, will it give you the relief you seek? Let's take a look at some factors that will help you figure out the value of a liquidated damages clause.

What are liquidated damages?

In general, liquidated damages are an amount of predetermined, stipulated compensation to be recovered upon the occurrence of a particular event. They are often associated with delays on a project. The purpose of having a liquidated damages provision is to establish a pre-set amount of payment to address circumstances where damages are hard to determine or otherwise difficult to prove.

Why would you include a liquidated damages provision in your contract?

There are a few reasons that come to mind:

- you prefer the certainty of the stipulated amount to the risk, cost, and uncertainty of proving actual damages, or
- one party makes it a part of contract negotiations, and you link it to getting something in return, such as an early completion bonus.

It pays to be careful when drafting a liquidated damages clause.

Just because your contract has a "LIQUIDATED DAMAGES" section, it does not mean that it is a valid clause or that you will recover under it. For example, the pre-set liquidated damages amount must be a *reasonable* estimation of the damages that would occur in the event of a breach. If the stipulated amount is not reasonably related to the potential damages, then it will be considered a penalty, and it will be unenforceable.

This is an important point. Even if both parties agree to include the clause in their contract, it may not be enforceable. While the freedom to bargain for and agree upon terms is a bedrock of contract negotiations, the law of liquidated damages puts some limits on this freedom.

One case tells a very instructive story. Despite the parties' apparent agreement to include a liquidated damages clause in their contract – after all, it was in their contract -- the party seeking to enforce the clause could not offer a reasonable explanation of *why* the parties included the clause and *how* the liquidated damages amount was calculated. On this basis, the court rejected the provision, saying it was not reasonable and calling it a penalty.

What is a reasonable liquidated damages provision?

Remember, whether the liquidated damages are reasonable is not affected by the amount of actual damages incurred because the analysis is based on the circumstances existing at the time the parties enter the contract. Accordingly, the following factors are relevant to determining what is reasonable under the circumstances:

- whether the clause is buried in "boilerplate" language or was freely negotiated,
- what the contracting parties thought at the time they entered the contract,

- the degree to which the contracting parties had knowledge about what might happen in the event of a breach, and
- the degree to which there is a reasonable explanation for how the stipulated sum was chosen.

In one case involving the construction of a church, the pastor of the church testified that the amount of liquidated damages, \$250.00 per day, related to the anticipated loss of donations or offering, tuition for a private school affiliated with the church, and the increased costs of building the church as time progressed. When considering whether to award liquidated damages, the court found that these factors supported the liquidated damages amount.

One last thing to consider is why there was delay in the first place. Even if you have a valid liquidated damages provision in your contract, you may not recover under it. If you, too, delayed the completion of the project or otherwise breached the contract, the court will consider your conduct when evaluating the merits of applying the provision.

Temple Baptist Church v. C & H Commercial Contractor, Inc., 2007 WL 4991302, at *1-*2, (Tenn. Ct. App. March 11, 2007); *Guiliano v. Cleo, Inc.*, 995 S.W.2d 88 (Tenn. 1999); *V.L. Nicholson Co. v. Transcon Inv. and Financial Ltd., Inc.*, 595 S.W.2d 474,484 (Tenn. 1980); *Eatherly Construction Co. v. HTI Memorial Hospital*, 2005 WL 2217078, at *5-*9 (Tenn. Ct. App. Sept. 12, 2005); *AirlineConstruction, Inc. v. Barr*, 807 S.W.2d 247, 262 (Tenn. Ct. App. 1990).

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