



Understanding Damage Clauses in Construction Contracts

By Thomas A. Littlefield of [Old Republic Surety Co.](#)



Disruptions to a project's progress always challenge the equitable management of construction contracts. The COVID pandemic has put a bright light on problem trends that have been developing over the last several years—shortages in skilled labor and volatile pricing and availability of material. Most recently, unprecedented disruptions in supply chain distribution on both national and global levels have exacerbated the likelihood and risk of being faced with expensive delay damages and claims stemming from material costs escalation.

Knowing that a contractor is aware of what to look for in a contract and has a well-thought-out strategy for mitigating damage claims can give a surety underwriter a good measure of comfort in that contractor's approach to risk mitigation. But the recent volatility in key construction components has elevated sureties' concerns about the significant financial exposure from delay damages and cost escalation.

It's worth revisiting the types of damage clauses likely to be found in a contract and to develop a strategy for dealing with these when negotiating contract terms and conditions.

A few cautions to remember about contract language

Actual damages: Compensatory damages (also called “actual damages”) cover the loss the nonbreaching party incurs when a contract is breached. The amount awarded is intended to make good or replace the loss caused by the breach. Actual or direct damages are the cost of completing a delayed project, or repairing, or replacing faulty work.

To be awarded actual compensatory damages, the plaintiff must prove that the damage and losses suffered equate to a monetary value that a judge or jury can determine. The burden of proof falls primarily on the project owner or general contractor (GC). Negotiating for actual damages can help keep damages from being used as a financial leverage.

Liquidated damages (LDs): This type of actual damages is the most common form of damages found in a contract. Parties to a contract use liquidated damages where actual damages, though real, are difficult or

practically impossible to prove. Courts have ruled that these LDs should be “a reasonable approximate of the actual anticipated damages from the loss of use of the project.” *Fred A. Arnold Inc. v. United States*, 18 Cl. Ct. 1 (1989).

In other words, the amount must be reasonable and cannot be punitive. From a surety’s perspective, contracts with delay damages limited to actual damages or to specifically defined liquidated damages calculated by a formulated schedule (x dollars per calendar day beyond y date), are better risk-mitigation mechanisms for keeping delay claims from getting out of control. Without a “not-to-exceed” dollar limit cap, they can become a financial catastrophe for a contractor—and its surety. Contracts with specifically stated damages provide a base on what are known and predictable contingencies, which can be evaluated and budgeted into the project.

It is still important to understand what “actual” damage considerations were likely used in setting the value, both to defend it against charges of being an unreasonable penalty or punitive in nature and also to evaluate and include exposure to these in a risk mitigation plan for the project. Creating a risk-mitigation plan, while going through the project’s cost takeoff estimate and critical path of work, can help in establishing internal contingency allowances and in negotiating completion schedules and final contract terms and conditions.



No-damage-for-delay clause: Also known as “no pay for delay,” this clause seeks to prevent costly disputes over who is responsible for a delay. The parties agree not to seek monetary compensation for damages and instead agree that the sole remedy for a delay will be an extension of time to complete the job.

While a no-damage-for-delay clause may not be a perfect solution, it does provide a way for parties to reach an equitable compromise and avoid lengthy and expensive litigation in the defense or pursuit of delay damages for money. Absent any specific damage clause, courts will often interpret contracts to be for actual damages. An agreement where the first recourse for delay is limited to additional time to finish a job can help keep everyone’s focus on getting the project completed. At the same time, adding in exceptions to allow for collection of monetary charges that are related to specific types of damages (cost for mobilization or demobilization) and for specific delays (that involve active interference from another party, fraud, bad faith, or gross negligence) should be made part of the no-damage-for-delay clause and may be enforceable depending on the laws of the state of jurisdiction.

Cross-project setoffs: While not damage clauses in and of themselves, cross-project setoffs are sometimes used when an owner or GC has multiple contracts with the same party. The clause allows the owner or GC to recover damages from one project by withholding payment on another project. In other words, if there is a problem with project A, an owner can take money from project B, even if project B is going well. These clauses definitely benefit the owner or GC, and it's best to remove them from the contract if you are the downstream party. They can allow the owner or GC an unfair leverage.

Consequential damages: These are the indirect costs a party incurs as a consequence of a delay. Because a delay may result in "consequential" damages, contracts often stipulate other means of compensation. Consequential damages can be a company killer because the contractor is essentially exposing its firm (and its surety) to "undefined and unlimited liability." Sureties will always urge contractors to negotiate these clauses out of their contracts. In these cases it is best to have a mutual waiver of consequential damages.

An example of the consequential damages risk can be found in the 1992 case, *Perini Corp. v. Greate Bay Hotel & Casino*, which arose from Perini's reconstruction of the façade of an Atlantic City casino. Perini was late in completing the project, and, while Perini's initial fee on the project was only about \$600,000, it was hit with an adverse award of \$14.5 million in consequential damages arising from the casino's lost revenues due to the late completion. From this case arose the 1997 revisions to the American Institute of Architects (AIA) contract documents, in particular, "A201 General Conditions." Beginning in 1997, A201 included a mutual waiver of consequential damages provision, which today (2017 version) reads as follows:

15.1.7 Waiver of Claims for Consequential Damages

The Contractor and Owner waive Claims against each other for consequential damages arising out of or relating to this Contract. This mutual waiver includes:

.1 damages incurred by the Owner for rental expenses, for losses of use, income, profit, financing, business and reputation, and for loss of management or employee productivity or of the services of such persons; and

.2 damages incurred by the Contractor for principal office expenses including the compensation of personnel stationed there, for losses of financing, business and reputation, and for loss of profit, except anticipated profit arising directly from the Work.

A mutual waiver protects both parties from excessive claims and should always be considered as part of a contractor's "walk-away" conditions. In essence, the owner and contractor are agreeing to waive consequential damages that could represent unlimited and undefined risks to each other.

Developing a strategy for dealing with damage clauses

Contractors should always consult with their attorneys prior to signing a contract. They should understand the various legal remedies available and the impact various damage clauses will have on the company's business.

The risk of consequential damages and LDs generally relates to a failure to complete a project or achieve a milestone on time. How do you evaluate all these risks and their consequences in today's pandemic environment? Start with making a full 360-degree assessment of the complexity of the project, the quality of the design documents, and your contract rights to obtain time extensions. Finally, determine the potential sum of total financial liability you would have if you failed to meet the completion schedule. Taking these all into account can help you evaluate how much delay damages risk you are willing to take.

To survive—let alone to succeed—in today's construction environment, a contractor needs to have a broad group of professionals with sharp skills in their fields of expertise and needs to apply all of their resources and business acumen to fully understand and evaluate the risk on every project if the contractor is to avoid the traps in these delay damages contract clauses.



Thomas A. Littlefield is Vice President, Director of Large Accounts, for [Old Republic Surety Co.](#), an A.M. Best A+ rated carrier member of Old Republic Insurance Group. With over 30 years of contract surety experience, Littlefield works with bond producers and their clients through Old Republic's network of regional offices to support large and complex accounts with surety bond needs in excess of \$100 million.

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7735 Old Georgetown Road, Suite 900, Bethesda, MD 20814 240.200.1270