

Three Factors to Consider When Including a Liquidated Damages Clause in Your Texas Construction Contract

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It is common in Texas to find construction contracts wherein the parties agree to damages in advance of a breach of the construction contract. These are liquidated damages and a provision that contains these damages is known as a liquidated damages clause. Despite how common these clauses are, not all of them are enforceable. In fact, under Texas law, a liquidated damages provision is an unenforceable penalty **unless (1)** the harm caused by the breach is incapable or difficult of estimation **and (2)** the amount of liquidated damages is a reasonable forecast of just compensation. This two-part test is known as the "Stewart test." So while Texas recognizes the parties' power to contract, it balances the use of liquidated damages clauses with the long-established rule of law that a party should be awarded her **actual** damages—no more and no less.

So if you intend on including an **enforceable** liquidated damages provision in your construction contract, rather than an unenforceable penalty, ask yourself three things: (1) can I calculate actual damages for this specific breach?; (2) are the agreed-upon damages a reasonable forecast of just compensation?; and (3) am I impermissibly including an actual damages multiplier?

First: Can I calculate actual damages for the specific type of contractual breach?

If it is easy to determine damages for a specific type of breach of the construction contract, then that specific breach **does not** allow for the use of a liquidated damages clause. For example, if the builder fails to include a specific item or does so in a manner that does not conform to the plans, the damages associated with the item can be calculated by looking at the price of the item and/or associated labor for removing and replacing the item. In situations like this, liquidated damages are inappropriate.

If, on the other hand, there are too many potential market variables (or it will require an unreasonable expense) at the time the contract is being signed to accurately determine the damages associated with a specific breach, then a liquidated damages clause may be your answer. A proper liquidated damages clause permits the parties to agree to a reasonable amount of damages in light of the difficulty and uncertainty associated with attempting to prove actual damages after the breach occurs. For example, owners and builders routinely agree to include a liquidated damages provision for the builder's failure to timely complete construction of a project. Untimely completion may implicate numerous obligations and costs, several of which are highly variable depending on the timing and market conditions (e.g., a fall market may be more seller-friendly than a spring market).

Second: Are the agreed-upon damages reasonable?

If the agreed-upon damages are arbitrary or result in a windfall for the recipient, then Texas courts will likely find the clause to be an unreasonable and unenforceable penalty. When entering into the contract, savvy owners and builders should make an effort to formulate an estimated range of damages for those breaches for which they intend to include in the liquidated damages clause. While almost definitely failing to meet the precision required for proving actual damages in a lawsuit, by building an estimated number based on all the factors and conditions of which each party is aware of at the time, the parties may establish the baseline for reaching an enforceable and reasonable amount of liquidated damages. The more analysis put into the forecast of these uncertain and difficult to establish damages during the contracting stage, the more likely the parties are to agree to a number that is reasonable when compared to the actual damages that can later be proven for the breach in question.

Texas courts examine the reasonableness of a liquidated damages clause on a case-by-case basis. In making this determination, however, Texas courts are commonly faced with comparing the agreed-upon damages amount in the contract with the actual damages suffered from the loss as established by the evidence. It does not help that, in this context, Texas law has not clearly defined "reasonable." On one hand, Texas courts have enforced liquidated damages clauses that resulted in agreed-upon damages up to three and one-half (350%) times the actual damages suffered. On the other hand, Texas courts have found liquidated damages that were four and one-half (450%) times the actual damages suffered were unreasonable and therefore unenforceable penalties.

Third: Am I simply including an impermissible damages multiplier?

Some construction contracts permit the owner to obtain a multiple of the amount of actual damages the owner suffers if the builder does not timely complete construction. Those same contracts may also permit the builder to recover from the owner a multiple of the actual costs the builder suffers if the owner breaches a specific provision of the contract. These are classic examples of "multiplier clauses" and they are unenforceable penalties.

Damages clauses that simply multiply the actual damages suffered in the event of a breach fail both parts of the "Stewart test." These clauses fail the first test, requiring difficulty and uncertainty of the actual damages that would be suffered, because a multiplier clause assumes actual damages can be calculated and, in fact, requires that they first be calculated then multiplied by the agreed-upon number. Multiplier clauses fail the second test, that the agreed-upon amount is a reasonable forecast of just compensation, because the parties are not attempting to forecast actual damages when contracting. Rather, the parties are agreeing to later determine actual damages and then multiply that amount by an agreed-upon number. Multiplier damages clauses expressly permit a party to recover more than their actual damages and as such, fly in the face of the rule that a party should be able to recover their actual damages—no more and no less.

Conclusion: It is important to know when and how to use a liquidated damages clause. In instances of high uncertainty and/or difficulty in determining the actual damages attributable to a specific type of contractual breach, properly drafted liquidated damages clauses will carry the day. In the event the builder or owner is suing you and attempting to enforce a liquidated damages clause for breaching the construction contract, knowing the law and having the right counsel to defend you could make the difference between winning and losing. If your company needs assistance analyzing, prosecuting or defending against a liquidated damages clause, I am happy to help and can be reached at 214-777-4270 or rhathaway@krcl.com.

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