New Jersey Law Journal
STATEWIDE LEGAL AUTHORITY SINCE 1878
An ALM Publication
OCTOBER 21, 2019 NJLJ.COM

REAL ESTATE & CONSTRUCTION LAW

Liquidated Damages and Stipulated Sums: Excavating the Truth of Liquidated Damages Provisions

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In my 40 years of practice, I have consistently found that practitioners do not understand the area of the law dealing with liquidated damages and stipulated sums provisions. Yes, they can quote the hornbook law of *Williston*. And they can advise that the parties have a broad right to stipulate in an agreement the number of damages recoverable in the event of a breach, especially in circumstances where the actual damages likely to flow from the breach would be difficult to estimate or prove. But the requisite familiarity with these concepts does not end there. Indeed, it is hardly the beginning.

Attorneys frequently fail to grasp the major counterbalance point set forth in *Williston*—that liquidated damages clauses will be held to violate public policy, and will not be enforced, if they have the effect of punishing a party as opposed to representing actual damages. One such example is when a large disparity exists between the amount payable pursuant to such a clause in comparison to the actual damages incurred. It is this scale of liquidated damages analysis with one side being the damages per the clause and the other side being the actual damages at the time of the breach that most do not understand.

Lawyers should also keep in mind that even if they are successful in defeating a liquidated damage clause, as I have been on several occasions, it does not mean that the coast is clear. Exposure for any actual damages that the breach caused remains to be addressed. However, in many situations where there is not a revenue-generating facility, which is common, there really will not be much in the way of actual damages experienced by the owner.

My area of practice is in construction law, where liquidated damages provisions, or its cousin the stipulated sums provision, are very common. Examples include clauses obligating a contractor to pay a project owner $X per day that a project is completed beyond a set

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date, or set monetary deductions based on not achieving the required percentage of compaction for asphalt. However, despite their pervasiveness in the industry, the point most often missed is that these dollar amounts need to be based on actual damages incurred. A project may be substantially complete and in full use by an owner, but the owner still wants to assess $X per day because the punch list is not complete. In such instances, the actual damages incurred by the owner most likely do not support that claim. This is because the owner is able to substantially use the property or facility for its intended use, the owner's actual damages, if any, are likely lower than the amounts set forth in the liquidated damages clauses. Many times the owner is attempting to use the liquidated damages as a hammer—more akin to a penalty than a remedy, which is problematic. These tactics make liquidated damages provisions vulnerable to being deemed a penalty and thus void as against public policy. We have successfully attacked millions of dollars of threatened liquidated damages claims on this basis. However, practitioners must be aware of these distinctions and their interplay with construction contracts, especially in the context of rewards versus penalties.

Rewards Versus Penalties

Rewards are contextually defined as when someone is paid more money to perform a task. Rewards are legal, as are any type of incentive payment or bonus. On the other hand, penalties in the context of contracts, particularly those with public entities, are considered void as against public policy. A penalty is an amount charged as a punishment, the threat of which is designed to prevent the breach and not as compensation for actual damages incurred. Penalties stand in direct contrast to payments for damages suffered as a result of a breach of contract. They are not pre-estimates of probable actual damages and may have no reasonable basis or foundation when compared to actual damages.

'Westmount Country Club v. Kamney'

Kamney joined a country club and decided he would leave shortly thereafter. The club sought to evoke a portion of the membership contract signed by Kamney that would charge him the full yearly dues and deny him any refund. In the small world department, Kamney was represented by the future Justice Silvia Pressler. She submitted interrogatories seeking to discover what was the amount of "actual" damages suffered by the country club as a result of Kamney's leaving early. The country club refused to respond, and a motion to compel was filed that wound up in the Appellate Division (197 A.2d 379, 82 N.J. Super. 200 (App Div 1964)).

In upholding the motion to compel, the court found that the requested information was needed to determine actual damages and, thus, the enforceability of the provision. This case established a two-prong test to determine if a clause as to damages is enforceable. The first prong requires that the contractually fixed amount is a reasonable forecast of the just compensation for the harm caused by the breach. The second prong requires that the harm caused by the breach is incapable or very difficult of accurate estimation. *Id.* 382. In setting forth this two-prong test, the court directly ties the enforceability of a liquidated provision to a party's ability to prove actual damages.

'Wasserman's v. Township of Middletown'

In this case, the Township of Middletown leased some space from Wasserman's, Inc., and then sought to get out of the lease. In response to the premature lease termination, Wasserman's attempted to enforce a cancellation clause seeking payment of rental payments for the remaining term of the lease. The case made its way to the New Jersey Supreme Court (645 A.2d 100, 137 N.J. 238 (1994). The court voided the cancellation clause and sent the matter back to the trial court for a determination of the actual damages by the building owner.

The opinion includes a discussion of liquidated/stipulated and restated much of what was put forth in *Westmount*. The court found that liquidated damages are prima facie valid and that the burden is on the challenging party to show that they are unreasonable. The court found that the purpose of a stipulated damage clause cannot be to compel a promisor to perform but needs to be such as to compensate for the non-performance.

The court set forth what is referred to as the *Wasserman* test. The *Wasserman* test requires that the validity of a liquidated damages provision will be determined by analyzing *two* points in time. The first point in time considers an assessment of the reasonableness of the damage clause when the contract is made. The second point in time considers an assessment of the reasonableness of the number of actual damages at the time of the breach.

The New Jersey Supreme Court further enforced this test in *MetLife Capital v. Washington Ave. Assoc*., 732 A.2d 493, 159 N.J. 484 (1999), wherein the court focused on the significance of reasonableness of enforcing a liquidated damages provision.

Case Study: NJDOT's History with Liquidated Damage

The New Jersey Department of Transportation (NJDOT), as one of the largest construction owners in the state, provides an apt case study on the enforceability of liquidated damages provisions. Prior to *Wasserman*, NJDOT used a table to determine liquidated damages. The table was comprised of a simple sliding scale based on the dollar value of the contract. The table then sets forth a fixed dollar value per day of liquidated damages based on the total contract value. This would obviously fail any type of *Wasserman* review because the sliding scale fails to consider NJDOT's actual damages. It was really an arbitrary system that would not pass a reasonableness test and lack any analysis as to the actual damages that NJDOT would incur should the project be extended.

In response to *Wasserman*, NJDOT currently uses a different system—one that is arguably equally flawed. This new system uses a per-project analysis that has two components. The first is proper. It is an examination of the actual costs for construction engineering and inspection if the project exceeds the original contract completion date—in effect, what costs NJDOT would actually incur if the project completion was extended. If this component was the only element in the analysis, contractual provisions setting forth this mechanism as a means for determining liquidated damages would be enforceable. This is because the number of liquidated damages equate to a reasonable estimate of the actual costs incurred, such provisions serve as permissible just compensation.

However, the NJDOT system goes a step further with the second component of its system for determining liquidated damages—"Road User Costs." The theory behind the "Road User Cost" is that as motorists drive through a construction site they are experiencing additional costs because the construction work slows down their travel through the impacted work area, thus damages are assessed as to their lost time and automobile costs for having to take longer to travel through a roadway due to the presence of construction work. There are many issues with this "theory." The first issue is that the damages are not those of the NJDOT itself, but are based on damages experienced by passing motorists (who may or may not be taxpayers of New Jersey). Second, it is entirely theoretical. It is based on a theory that the motorist will be delayed and would be applied whether or not that theory is borne out in reality. These are theoretical and not actual damages.

The second component of the NJDOT system stretches the definition of "actual" damages. While on its face, the system seems to be compensatory in nature as it bases the number of liquidated damages or actual costs incurred by an extended construction, this is a false predicate. Because these so-called "road user costs" are: (1) nor borne by NJDOT, and (2) are entirely theoretical in nature, they are penalties in disguise—and void as against public policy.

Variations of the Contractual Liquidated Damages Provision

Stipulated Sums – Stipulated sums are provided for where the contract sets forth a stipulated amount to be paid should the contract be breached. By signing and executing the contract, the parties are stipulating the sum of damages in the event of a breach. By way of example, a stipulated sums provision can be included in a contract that requires asphalt pavement to be compacted to 95% of its total compaction capacity. The contract may then provide a formula that applies a reduction in payment based on achieving percentages lower than the required 95%.

Stipulated sums provisions are held to the same standards as liquidated provisions. As such, the amount of the stipulated sums must include a reasonable connection between the amount of the deduction and the actual provable damages for failing to meet the contract requirement.

Disincentives/Incentives – Touched upon previously as to incentives, for which there is no problem, disincentives, are as their name suggests, are penalties. An example is a contract that provides for a $5,000 per day incentive for every day that a contractor bests the required completion date and a $5,000 disincentive for every day that it is completed thereafter. The incentive portion is valid, but the disincentive is not. We took this matter to the Alabama Supreme Court, please see, *Milton Construction Company v. State of Alabama Highway Department*, 568 So. 2d 784 (AL 1990). The Alabama Supreme Court found the disincentives to be invalid as their purpose was to ensure the earliest possible date for completion and that they were not intended as compensation for any delay.

Lane Rental/Occupancy Charges – Lane rental and occupancy charges present a gray area in the law. Found on roadway construction projects, these are charges that are assessed if a contractor does not get off a roadway with its equipment by a certain time. In effect, the project owner charges the contractor a fee for "renting" the roadway or improperly occupying the roadway. They can be extremely penal, and can run as high as $250 per minute. An exemplary scenario is that a project owner wants its contractor off the roadway by 7 a.m. each morning to minimize any negative impacts on morning commuter traffic. However, due to equipment breakdown, the contractor does not get off the roadway until 8 a.m. The Lane Occupancy Charges section of the contract states that the owner will have the right to collect a Lane Occupancy charge for the use and occupancy of each such lane or lanes beyond the permitted time. Because the contractor improperly "occupied" the roadway, the owner assessed a fee. Importantly, this is assessed whether or not a single car is backed up in traffic. The actual impact of commuter traffic is not even a factor. Frequently found in public roadway contracts, these "occupancy" charges are assessed regardless of actual costs incurred or not incurred by the project owner. I question the legality.

Reverse Liquidated Damages – Practitioners representing contractors should also be aware of reverse liquidated damages clauses. Reverse liquidated damages clauses entitle owners to be responsible to a contractor for a set amount of damages for each day a project is extended. On its face, a reverse liquidated damages provision appears beneficial to the contractor. However, such a clause can actually serve as a low ceiling compared to the contractor's actual damages. An example includes a public roadway contract that provided that if the owner extended the time for performance that the contractor would be entitled to be paid $1,000 per day. On behalf of the contractor, we moved to void the clause on the grounds that the contractor's actual damages were approximately $12,000 per day. The court agreed that this reverse liquidated damages provision failed the second prong of the *Wasserman* test. The court agreed that the $1,000 set forward in the reverse liquidated damages amount was unreasonable when compared to the actual damages, rendering it void as against public policy.

Conclusion

In summary, when faced with any of the above, practitioners should always compare the actual damages to the reasonableness of the liquidated damages set forth in a particular contract. In the event these two components do not coalesce, the clause can be held invalid. This can save a contractor client from paying punitive and theoretical damages, and instead limit the owner's damages just to those that are actual and reasonable in the eyes of the court. ■