

LIQUIDATED DAMAGES

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Liquidated Damages

Assuming a construction contract is in place, it is not uncommon to find a provision that provides for payment of a fixed amount, likely called "liquidated damages", should the contractor fail to complete by an appointed date or within a period specified for completion.

The issue that arises when considering to include such a provision in the construction contract is whether the amount specified is a true assessment or "genuine pre-estimate" of damages suffered by and, therefore, payable to the owner by the contractor as a result of contractor's failure to complete, or whether the amount is in fact a penalty.

In many cases it is difficult to determine at the pre-contracting stage what the owner's potential losses or damages may be and are triggered by the contractor's failure to complete. What is clear is that only those provisions that reflect a "genuine pre-estimate" of damages to be suffered by the owner on breach by the contractor are enforceable.

In other words, those provisions that provide for a payment of penalty by the contractor that are excessive and beyond the actual losses of the owner are generally void and unenforceable. In those instances, the owner's relief is a claim for damages flowing from any loss actually suffered as a result of the contractor's breach.

The danger is generating a provision that ultimately produces recovery for the owner that is far in excess of the actual losses. In that regard, any scenario that puts the owner in a position to recover more than their actual losses or damages incurred will likely result in the provision being struck down as being a penalty regardless of the parties' intentions.

In Canada, the leading case on liquidated damages is an old decision from the U.K. Courts¹, which came up with the following as "criteria" or factors to consider when addressing "liquidated damages" provisions:

- The use of the words "penalty" or "liquidated damages" in the contract is not conclusive or determinative of whether it is in fact one or the other. The Court must find out whether the payment stipulated is in truth a penalty or liquidated damages. In other words, the parties' attempt to call it "liquidated damages" is not conclusive and the Court can still determine that it is a penalty.
- The essence of a "penalty" is a payment of money stipulated as against the offending party; the essence of "liquidated damages" is a genuine covenanted pre-estimate of damages to the innocent party. The key is to attempt to estimate what actual loss would be caused by the breach by the offending party and further, whether it is fair and reasonable.

¹ English House of Lords case: *Dunlop Pneumatic Tyre Company v. New Garage and Motor Company Limited*, [1915] A.C. 79.

- The question whether a sum stipulated is penalty or liquidated damages is a question of construction to be decided upon the terms and inherent circumstances of each particular contract, judged at the time of the making of the contract, not at the time of the breach.
- To assist this task of construction of such provisions various tests have been suggested:
 - It will be held to be penalty if the sum stipulated for is extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have followed from the breach.
 - It will be held to be a penalty if the breach consists only in paying a sum of money, and the sum stipulated is a sum greater than the sum which ought to have been paid (i.e. greater than the actual losses of the innocent party).
 - There is a presumption that it is penalty when a single lump sum is made payable by way of compensation, on the occurrence of one or more or all of several events, some of which may occasion serious and others but trifling damage.

The time for assessment or construction of the provision as either a "genuine pre-estimate" of damages or a penalty is as at the time of the contract. In other words, if it is a genuine pre-estimate of damages or losses of the owner at the time the contract is entered, then it will likely be valid and enforceable.

Likewise, if the contractor is arguing that it is an unfair provision and it is a penalty, the proper time to assess that unfairness must be at the time of entering in to the contract. One would expect that this assessment would favour the owner on the argument that an experienced party such as the contractor would have assessed whether the inclusion of such a provision at the time of pre-contracting was fair and, if not, would either have negotiated against inclusion or would not have entered into the contract at all.

Failing that, the contractor would argue that the provision is not a genuine pre-estimate of damages and the amount expected to pay is greatly in excess of what the actual losses, if at all, have incurred to the owner.

Accordingly, rather than a lump specified sum as a payment for delay or liquidated damages by the contractor upon breach of the contract, the practice has evolved to a provision that provides for payment of a set per diem for delay in completing or failing to deliver the project by the appointed completion date.

However, wording a provision as such is not as easy as it sounds nor does it avoid the will of the Courts to hold contractual provisions that are unfair to the offending party in equity as being unenforceable.

Therefore, a liquidated damages clause must have a mechanism for determining an amount for payment that has some relevance to the actual losses of the owner and resemble a genuine attempt at estimating those losses that have a reasonable likelihood of occurring in the event of a breach.

If the provision does not meet these criteria then the amount payable and the provision in the contract relating thereto are a penalty and are unenforceable.

Alternatively, if the amount is not excessive and bears some resemblance to the actual losses of the owner then the provision will generally be upheld by the Courts as a genuine estimate of damages likely incurred. As long as the amount in the provision is commensurate with the owner's probable actual loss then the provision may likely be valid.

Putting aside the debate over whether the provisions is a genuine estimate of damages or a penalty, the event potentially triggering the provision must be one caused by the contractor or for which it was responsible. As a result, the onus will be on the owner to prove that the event was caused by the contractor. If the owner meets that burden, the amount payable under the provision becomes a debt owing by the contractor.

Other issues to be aware of in the context of liquidated damages provisions is the potential for conduct on the part of the owner to be held as a waiver of the application of the clause or payment of same by the contractor. For example, although not always the case, the taking of possession of the project by the owner may constitute a waiver of the payment of damages for delay.

Another example is in the context of granting an extension of time to complete. Although granting such an extension may be a waiver of the right to enforce liquidated damages provisions, if the contractor fails to perform and deliver by the extended completion date, the owner's right to enforce the payment of liquidated damages may be re-triggered.

Alternatively, if the owner orders extras or make numerous changes to the contract and deliverables, these may be held to be a waiver of the right to enforce and recover liquidated damages if the contractor's ability to complete is directly affected by these changes.

Even in the instances where the parties avoid the lump sum trap but rather base the assessment of "liquidated damages" upon a formula, where the formula results in an amount that is far in excess of any actual loss or damage, the Courts will not hesitate calling that formula "grossly excessive and punitive" or otherwise disproportionate such that it is a formula for a penalty rather than liquidated damages².

If a contractor fails to complete work by a specific time as required under a contract due to the actions of the owner (e.g. delay by the owner in ordering essential equipment or having it installed), the contractor is relieved of any duty to pay any liquidated damages stipulated in that

² Supreme Court of Canada case: *H.F. Clarke Ltd. v. Thermidaire Corp.*, [1976] 1 S.C.R. 319.

contract³. In these instances, any time extension clause may also not retain the applicability of any liquidated damage clause relieving the contractor from any liability for liquidated damages.

One way to potentially avoid the provision being held a penalty clause is to provide that the mechanism is a discount on amounts otherwise payable to the contractor. A deduction in the amount payable as liquidated damages⁴ where a contract for construction provides for a per day deduction on the contract as an amount for delay is a valid mechanism. However, it is important to note that the ability to rely on such a discount may be vitiated in the event that the contractor issues a certificate of completion and acceptance of same by the owner is viewed as a waiver to claim a discount against amounts owing.

Other ways to frame a liquidated damages provision is the form of a surcharge payable by a contractor relating to the cost to repair poor or defective workmanship⁵. However, caution should be exercised when coming up with the mechanism in which the surcharge is imposed. For example, a clause permitting a deduction of the value of any incomplete portions of work done by a contractor from the contract price plus a surcharge of 50% of that cost as damages would be considered the imposition of a penalty⁶.

A letter of credit can also be a valid pre-estimate of damage and thus constitute valid liquidated damages. For example, a letter of credit used as a mechanism to guarantee a result may be considered a "genuine pre-estimate of damages" and not a financial penalty⁷. As a result, drawing down on the letter of credit would be the means by which an owner could enforce that guarantee.

Interestingly, if an owner's actual losses exceed the amount specified as payable in the provision that may serve to the benefit of the contractor who would only be obligated to pay that amount and no more. Any excess losses befall upon the owner's shoulders. In other words, the owner cannot recover the full amount of actual losses because the contract provides that that the agreed upon sum or formula shall be the limit of the contractor's liability to the owner.

Alternatively, if the amount specified in the contract exceeds the actual losses, the amount in the contract may still be payable by the contractor as long as it is not grossly excessive or wholly disproportionate to the actual losses. This serves to the benefit of the owner.

Ultimately, the basis upon which the Courts tend to rest their conclusions is on whether a true construction of the clause was intended to limit damages, both to secure a payment to the owner and the amounts thereof payable by the contractor. If the parties can generate a mechanism that accomplishes this goal then the provision will likely enforceable and will otherwise be upheld.

³ *Perini Pacific Ltd. v. Greater Vancouver Sewerage & Drainage District* (1966), 57 D.L.R. (2d) 307 (B.C.C.A.), affirmed by [1967] S.C.R. 189.

⁴ *Janse-Mitchell Construction Co. v. Calgary (City)*, [1919] 3 W.W.R. 150 (S.C.C.).

⁵ *New Home Warranty Program of Manitoba Inc. v. Nagam* (1991), 48 C.L.R. 170 (M.B.Q.B.).

⁶ *MacDonald v. Northwest Biscuit Co.*, [1924] 1 W.W.R. 795 (A.B.C.A.).

⁷ *Edmonton (City) v. Triple Five Corp.* (1994), 22 Alta. L.R. (3d) 289 (Q.B.).