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Court Ruling Gives Renewed Clout to Liquidated Damages

BY ANDREW BERNE

There is a new law on the books that will affect contractors and design-builders doing business in Utah.

The Utah Supreme Court recently simplified the test that determines whether a court will enforce a liquidated damages clause. The clause provides a way to calculate damages up front if there is a breach of contract or a delay in project completion.

When the contract is breached, the law aims to restore both parties to where they would have been had the contract been fully performed.

Liquidated damages clauses are sometimes viewed as penalizing a contractor for delays. In Utah, as in many other states, courts generally hold such penalties to be unenforceable. But courts usually will not rewrite a contract, even if it is not entirely fair, preferring that parties contract freely amongst themselves.

Courts have historically used three different tests to determine enforceability. One test examines whether liquidated damages are a penalty and therefore unenforceable. Under a second test, the court weighs contracted damages against actual damages. A third test was sometimes used by applying principles outlined in the restatement of contracts, which originally assumed that a liquidated damages clause was unenforceable.

But in a recent case, the Utah Supreme Court discarded all three tests because there has not been a clear and objective standard for determining enforceability. The court has now constructed a simplified rule to govern liquidated damages cases subject to Utah law. In the case of "Commercial Real Estate Inv. v. Comcast of Utah II, Inc.," the court rejected previous standards of enforceability and decided that liquidated damages clauses are to be treated like any other contract clause.

That means they are unenforceable only if there is evidence of unacceptable behavior according to industry standards. The court's decision in the case also affects challenges to enforceability. Courts now initially presume that liquidated damages clauses are enforceable, and it is the burden of the party challenging the clause to prove otherwise.

To determine whether a clause is unenforceable, the court now follows a two-part test:

- Does the substance of the liquidated damages clause create an imbalance in the duties of the parties beyond acceptable industry standards?
- Did one party inappropriately use its superior bargaining power in a way that harmed the weaker party?

The change in the law dealing with liquidated damages clauses seems to have removed some of the question of whether or not such a clause will be enforced. As a result of the court's decision, owners may now be encouraged to include liquidated damages clauses in contracts more often because the standard for enforceability has been simplified. Unless the liquidated damages clause is determined to be beyond what is generally accepted in the industry, it will be enforced. An aggrieved party cannot claim that enforcement of a clause is unfair or harsh because liquidated damages clauses are now subject to the same standards as other contract clauses. Contractors should presume that liquidated damages clauses will be enforced, even if those clauses are to a firm's detriment.

The bottom line: Read the contract, assess the risks in relation to the contract benefits and, when needed, consult legal counsel for advice and recommendations. ■