

## Accounting for Liquidated Damages and Latent Defects

By John Dolce



*Including the penalties associated with liquidation damages and latent defects in a vehicle spec during the bid process can protect against unexpected costs.*

### At a Glance

Discuss these points to avoid extra costs:

- Set a delivery deadline.
- Define corrective action for deviations in delivery times.
- Per diem penalty for maintenance on older units.

As a fleet manager, you spec and order cars and light trucks and have a lifecycle program to maintain predictable and stable costs. You define configurations and predict delivery times based on resale values to maximize returns.

Vocational medium- and heavy-duty trucks follow the same pattern as cars and light trucks, except for resale values.

More attractive than timely resale is targeted replacement times based on a vehicle being used up and replaced prior to rebuilding major components and/or rebuilding the entire vehicle.

If a medium- or heavy-duty vehicle can be rebuilt at half the cost of buying new and last at least three-fourths the life of a new vehicle, then that is a viable alternative. The most cost-effective plan is to replace the old medium- or heavy-duty trucks and equipment just before extra unplanned maintenance costs are incurred. A fleet's budget plan can be thrown off if a major component wears out, such as the engine, hydraulic system, or drivetrain, premature to the intended replacement date.

### Timing is Everything

When a new vehicle arrives "turn-key," the old vehicle should be retired and sold to manufacturers or their dealers prior to any major repair cost or crushed to avoid any liability issues.

Problems can arise when a new vehicle is delivered late, potentially forcing a fleet manager to invest in major repairs in the old vehicle. Application specific vehicles that cannot be rented leave a manager no choice but to spend the unscheduled dollars to provide the end user the vehicle he needs to generate revenue.

Even if a vehicle can be rented, the additional expense of renting impacts the planned lifecycle costs.

Maintaining control of the process is important. Cost control of the delivery can involve various issues, including liquidated damages and latent defects.

Writing a functional specification for the chassis, body, and mounted equipment better ensures that the manufacturer will build and deliver a unit capable of performing the necessary functions and tasks.

### End-User Satisfaction Reigns

The end user must be completely satisfied with the new vehicle to accept it and give up the current vehicle it has that is due for replacement. In fact, if this event is not completed for 100 percent of end users, they will be suspicious of the design of the new vehicle and passively refuse to use it.

End users who decline to turn in old vehicles cause a fleet department to incur the costs of the old and new vehicles.

The timely turn-key delivery process is critical. It must occur per agreement of all parties, including the manufacturer, mounted equipment dealer, fleet manager, and the end user.

The boiler plate terms and conditions attached to the functional specifications must define rewards, penalties, and corrective action for deviations in delivery times. The two areas that define this are: liquidated damages and latent defects.

These items should be included in the functional specification submitted for bid using appropriate language in the terms and conditions. Furthermore, you should fully explain and discuss these items with the bidders in the pre-bid meeting.

Simply put, liquidation damages result when a vehicle is delivered without being completely operational. The functional spec should include what will happen if this occurs.

The spec should state that a per diem penalty would be attached to a reduction in purchase price to cover the extra maintenance costs needed by the old unit being replaced later than planned for. This could be \$100 per day or any amount deemed appropriate. The price per diem would be deducted from the purchase price until the unit is fully functional and/or turn-key.

Furthermore, if the unit is not fully functional within 60 days of the delivery date, it should be returned to the successful bidder for a complete refund.

#### **Create Leverage to Control Costs**

When a unit is delivered, it is accompanied by a manufacturer's statement of origin (MSO) so the vehicle can be registered. The fleet can agree to pay 70 percent of the full price upon delivery and pay prime interest on the 30 percent withheld until the vehicle is fully functional. If a 14-day period passes, \$1,400 is deducted from the purchase price and prime interest is paid on the 30 percent withheld minus the \$1,400.

This process gives the fleet leverage to hold the bidder to a turn-key delivery. Once the fleet's end user accepts the new vehicle, it can turn in the old vehicle. Without this leverage, the fleet manager is at the mercy of the bidder.

If there have been delivery problems in the past, this strategy should be implemented. If not, then a decision based on cost should be evaluated because the bidders could build this penalty into the price.

The additional cost is fueled by the competition between the bidders. Should they know there were turn-key problems in the previous bid, a more aggressive approach will be taken by the new bidders for the fleet's business.

As long as the cost of the cure does not exceed the cost of the disease, you are on track. A proactive approach is good for all parties. It's up to the fleet manager to create an environment for leverage through cost containment - cost efficiency by defining the process.

The second support strategy involves latent defects. These are design problems that evidence themselves because of poor materials or poor workmanship that cannot be seen or discovered by inspectors during a careful inspection or a known or customary test.

A vehicle frame's strength is measured using hardness tests to determine its ability to resist bending moments. If a frame fails during the second year of use, the manufacturer repairs it by fish plating and recovers the cost from the supplier of the frame. No known customary test could be performed in advance to catch this defect.

This example can be extended further to illustrate implied warranty. Unless damaged, frames have a service life of more than 20 years because of the materials put into them.

If a frame breaks at 10 years, you have grounds for reclamation of repairs from the manufacturer based on implied limits.

#### **Preparation Rather Than Desperation**

Expectations may need to be redefined if defect repairs covered under warranty have created problems with local dealers in the past.

Some dealers provide marginal repair services that do not follow the spirit of intent of the warranty. This is another area where the fleet manager can control and define the fleet leverage of enforcement.

All in all, it is the responsibility of a fleet manager to create a proactive environment that gives his companies leverage to support their expectations