

ENFORCEABILITY OF LIQUIDATED DAMAGES CLAUSES

By Richard Pennington



“ No branch of the law is involved in more obscurity by contradictory decisions than whether a sum specified in an agreement to secure performance will be treated as liquidated damages or a penalty.” – Illinois Supreme Court, 1917

Two recent case decisions cover the enforceability of liquidated damages amid claims that they operate as unenforceable penalties. For well over a century, enforceability has been a live issue in contract litigation. In August, Utah’s Supreme Court revisited the issue and appeared to soften somewhat the amount of judicial scrutiny of liquidated damages clauses.

THE TRADITIONAL PENALTY ANALYSIS

NIGP’s Online Dictionary of Procurement Terms defines liquidated damages as “[d]amages paid usually in the form of a monetary payment, agreed by the parties to a contract which are due and payable as damages by the party who breaches all or part of the contract.” The damage amount (or formula for computing damages) is specified in a contract clause. In construction contracts, liquidated damages commonly are stated as an amount assessed per day of delay.

Some states have statutes specifically prescribing requirements for liquidated damages in construction. For transactions in goods, section 2-718 of the Uniform Commercial Code authorizes the use of liquidated damages where they are reasonable and not a penalty. Common court formulations for the penalty analysis include: (1) whether the amount of liquidated damages was a reasonable forecast of actual damages; and (2) whether actual damages were incapable of being accurately estimated – or very difficult to estimate – at the time of contract formation. Thus, liquidated damages are forward-looking: The parties, in effect, are agreeing on an amount of damage that will be assessed because the amount of actual damage is difficult to determine.

The court opinions addressing the issue of enforceability are not unique to public procurement. Like most other contract interpretation and administration issues, the law regarding enforceability of liquidated damages largely is derived from cases involving private companies and individuals.

State courts have taken a range of approaches



to enforceability. Some opinions seem to resurrect almost insurmountable proof obstacles, including resolving doubts against enforceability of liquidated damages where there is a “reasonable doubt” about whether the clause operates as a penalty. Other court decisions appear more willing to permit the parties the freedom to contract and stipulate an amount to compensate for breach.

UTAH CHANGES ITS ANALYSIS

In an opinion published in August, the Supreme Court of Utah acknowledged confusion in its own (and other states’) courts about the test for enforceability of liquidated damages. [*Commercial Real Estate Investment, L.C. v. Comcast of Utah II, Inc.*, 2012 UT 49, Supreme Court of Utah, August 10, 2012] In the CRE case, Comcast was assessed liquidated damages in a lease providing that 1/30th of the monthly rent would be forfeited for every day that Comcast failed to continue operating its business there. Comcast had ceased operations in the building, and the landlord CRE assessed a total of \$1.7 million in liquidated damages for the five years period before a replacement tenant was found.

The Utah Supreme Court described various approaches to analysis of liquidated damages. One line of cases generally considers whether the court believes the damages are a penalty, often using post-breach hindsight not available when the contract was executed. The court decided to adopt instead the same review standard used in interpreting other contractual provisions. Under this approach, liquidated damages clauses (like other contract provisions) are presumed to be valid, shifting the burden to prove unconscionability to the one challenging it. The court reviewed the clause from a substantive perspective – whether its terms were so one sided as to be grossly disproportionate to actual damages as to be oppressive – and found it enforceable. The court’s language expressly abandoned the heightened judicial scrutiny that had characterized prior Utah case law on the subject.

ADMINISTRATIVE BURDEN AS DAMAGES

Often one cannot quantify the value of the additional time spent on a delayed project. Can a liquidated damages provision be based on increased oversight from a delay? In a South Carolina case last year, the answer was “yes.” [*Erie Ins. Co. v. Winter Const. Co.*, 713 S.E.2d 318 (S.C. App. 2011)]

Winter Construction was the general contractor on a major construction project for a school district. Winter eventually terminated for default its electrical subcontractor, making Erie – the bonding company – entitled to the claims of the terminated subcontractor. On \$3.1 million of completed, electrical subcontracted work, Winter withheld \$350,000 from Erie based on the provision in the subcontract permitting withholding of a specified amount as an “allowance for administrative burden.” Erie, the surety, filed a breach of contract action.

The trial court had held the administrative burden provision to be an unenforceable penalty. The court of appeals reversed, applying traditional penalty analysis. The court noted that liquidated damages are widely used in construction. Where the sum stipulated is reasonably intended by the parties as the predetermined measure of actual damages in the completion of the project, and not as punishment for breach, then it is not a penalty. In this case, the court reasoned, the general contractor would have suffered an “administrative burden to oversee the timely completion of the project.”

The court considered the fact that it would have been impossible to estimate the administrative costs in the event of default, given the complexity of a phased construction project. Winter would have been required to inspect work completed, determine the amount of remaining work, analyze bids from other vendors, oversee the completion using its own senior management officials, and otherwise administratively coordinate and manage the completion of the electrical work on the project. The court also considered evidence that the method of stipulating the amount of damages in the contract was consistent with industry practice. So despite the fact that the liquidated damages withheld were four times the actual damages, the court emphasized that the inquiry is on whether the stipulated amount is disproportionate to probable damage at the time of contracting. The court concluded that the liquidated damages provision was not a penalty.

IMPROVING YOUR CHANCES

Your state’s law will have its own approach to enforceability of liquidated damages, particularly

with respect to the relevance of actual damages to the analysis. There probably still are more jurisdictions applying the traditional penalty analysis than Utah’s “freedom to contract” approach.

This article addresses only one aspect of liquidated damages. Other issues you would want to discuss with your counsel include how long liquidated damages can be assessed, how concurrent delay caused by the government is treated (in some states concurrent delay precludes enforceability of the liquidated damages provision entirely), and to what extent liquidated damages preclude other remedies or claims for damages from breach.

With respect to enforceability, here are some general guidelines for improving the prospects that your liquidated damages clauses will be held valid:

- > **Avoid the use of the term “penalty”** in the title or text of the liquidated damages clause. Although there are cases that say that the use of “penalty” in the clause does not preclude a finding of validity, use of that term does not help with the characterization.

- > **Involve the user** and other functional experts in the calculation of amounts in order to align with industry practice in your jurisdiction.

- > **Include a brief memorandum** that describes the considerations in the types of damages, using available wage or consultant rates that quantify the hourly costs associated with oversight and inspection that occur during any delay. Without a memorandum, it’s difficult to later reconstruct what was considered in the computation.

- > As the Erie court did, **list the types of oversight, inspection, and project management activities** that would be required from delays and other covered breach, including lost opportunities on other projects that could fairly be characterized as damages from breach.

Where there are other damages that warrant additional liquidated damage amounts, supplement the general rate memoranda prepared for normal project delay. Include analysis that increases standard daily rates to account for other types of possible damaged, i.e. lost revenues, cost of interim facilities (e.g. rent), or other project-specific damages. ◀

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