Challenging a Liquidated Damages Provision

Overview

More than a decade has passed since the movie Jerry McGuire introduced a simple, four-word phrase that cleverly captures the essence of many business transactions: “Show me the money!” In no other area of law is the essence of this phrase more applicable than in construction litigation. Construction disputes, by and large, arise because of money. A party in a construction dispute generally seeks to recover money in order to receive the benefit of its bargain, or it wants to limit its financial exposure resulting from an alleged failure to abide by the terms of the construction contract. Thus, it comes as no surprise that construction contracts oftentimes contain provisions that specifically deal with the issue of damages. One such provision is the liquidated damages (“LDs”) provision.

A liquidated damages provision is basically an agreed-upon settlement of the anticipated actual damages arising from a future breach of contract, for example, late completion. Liquidated damages provisions allow contracting parties to protect themselves against the difficulty, uncertainty, and expense that necessarily follow the effort to prove actual damages. Although the concept behind LDs appears straight-forward, liquidated damages provisions are frequently challenged. Consequently, courts have adopted different guidelines, which vary from jurisdiction to jurisdiction, to determine the enforceability of such provisions.

Tests for Validity of LDs

Although the enforceability of a liquidated damages provision is a question of law for a court to determine, that analysis requires a close examination of the facts, including the contract, the language of the specific contract provision, and the methods used to compute the liquidated damages rate. Courts have held that an enforceable liquidated damages provision cannot be a penalty. The distinction between a contractual penalty and valid liquidated damages provision is that a penalty, in effect, is a security for performance, while a provision for LDs requires a sum certain to be paid as compensation for a breach of contract. In determining whether a liquidated damages provision is a penalty, a court evaluates two main considerations: (1) the reasonableness of the dollar amount stipulated and (2) the difficulty of determining and proving actual damages in the event of the breach.

First, the court examines if the stipulated amount is conscionable. This means that the amount stipulated is reasonable in view of the contract’s value and the probable or presumptive loss in case of breach. To determine whether the amount stipulated is reasonable, courts have developed two approaches. The prospective approach examines the reasonableness of the liquidated damages rate at the time the contract was executed. The retrospective approach uses hindsight to determine the reasonableness of the rate by comparing the actual damages sustained with the liquidated damages. If the discrepancy between the actual damages and the liquidated damages rate is very large, courts that apply the retrospective approach will find that the liquidated damages provision is a penalty, and will thus invalidate it. Some courts use both the prospective and the retrospective approach to determine whether a liquidated damages provision constitutes a penalty.

Second, the court examines the nature of the transaction to see whether the amount of damages resulting from the default would be easily and readily determinable. A liquidated damages provision is more likely to be upheld if it would be difficult to determine the amount of damages following a breach of contract.

Kansas: A Case Illustration

The analysis used by the courts to determine the enforceability of liquidated damages provisions is illustrated in Carrothers Constr. Co., LLC v. City of South Hutchinson, 207 P.3d 231 (KS 2009), a recent Kansas Supreme Court case in which that court rejected the retrospective analysis for determining the enforceability of liquidated damages provisions.

Carrothers Construction (“Carrothers”) entered into a contract with the City of South Hutchinson (“City”) to construct a $5,618,000 wastewater treatment facility to replace an existing
The contract contained multiple completion dates as well as a liquidated damages provision for delays in meeting the completion dates. Carrothers failed to complete the work by the contractually established completion dates.

The liquidated damages provision provided that time was of the essence, that it would be difficult to prove the actual loss suffered by the owner if the work were not completed on time, and specified LDs at $850 per day for failure to achieve substantial completion and final completion on time. To compute the LDs rate, the City hired an engineering firm that based the liquidated damages rate on several factors. These factors included the cost to monitor the project, additional labor costs, additional use of utilities, the cost of engaging another consultant, legal expenses, equipment rental, possible action by the Kansas Department of Health and Environment, and other unknowns in the event the project was not completed on time.

Carrothers was 170 days late in reaching substantial completion, and one day late in reaching final completion, bringing the total delay to 171 days. When the City withheld $145,350 in liquidated damages (171 days x $850/day), Carrothers challenged the validity of the liquidated damages provision, arguing that the specified rate was a penalty having no relation to the actual damages that the City had suffered. In effect, Carrothers used the retrospective approach. The court, however, rejected the retrospective approach in favor of a prospective analysis of the liquidated damages clause.

After rejecting the retrospective approach, the court compared the liquidated damages amount of $145,350 to the total contract price of $5,168,000, and found the amount of liquidated damages to be reasonably in proportion to the contract price. The court also compared the $850 per day rate to all foreseeable costs at the time the contract was entered into, both for the substantial completion and final completion stages of work, and found the liquidated damages estimates for both to be reasonable.

Carrothers also argued that the City waived its right to further liquidated damages when it occupied a partially completed facility. The court disagreed. To dispose of this issue, the court examined the language of the entire contract, as well as the language of the liquidated damages provision. Neither the contract nor the liquidated damages provision provided that liquidated damages would be waived if the City moved into the partially completed building; instead, the contract and the liquidated damages provision held that substantial and final completion had to be done by a certain date, and that any subsequent delays thereafter would cost Carrothers $850 per day. In other words, the court simply enforced the contract and the liquidated damages provision as written.

Practical Tips

For those engaging in construction projects in any jurisdiction, the first and most important lesson from Carrothers is an appreciation of the different approaches for determining the enforceability of LDs provisions. For example, in Kansas, the reasonableness of the liquidated damages estimate is determined by applying only the prospective approach. The rejection of the retrospective approach increases the chances that a court will uphold a LDs provision because the breaching party cannot use actual damages to show that the liquidated damages estimate is unreasonable. This, however, may not be the law in all states. Therefore, be sure to check the law of the state where the project is located.

When drafting a liquidated damages provision, ensure that the provision is not a penalty, or a security for performance. Avoid using the word “penalty” in a liquidated damages provision. The language of the liquidated damages provision should also clearly explain that actual damages would be difficult to ascertain, and that therefore the parties choose to use the liquidated damages in case of breach rather than requiring proof of actual damages. Use reasonable factors to accurately compute the damage estimate. Good factors to base LDs estimates on include the additional costs of labor, additional costs to monitor the project, additional utilities use, costs of engaging other consultants, legal expenses, and equipment rentals. Consider hiring a professional engineering firm or other business entities that specialize in forecasting construction costs when trying to come up with an estimate. In addition, make sure that the LDs estimate is a reasonable percentage of the total cost of the project.
Taking these steps will decrease the chance of a court viewing the liquidated damages provision as a penalty, which will in turn result in the creation of an enforceable penalty provision.