Challenging a Liquidated Damages Rate

Introduction

Construction projects are inherently uncertain. Factors such as differing site conditions, design defects, concurrent delays, poor workmanship, and adverse weather conditions can all affect the timely and successful completion of a construction project. Even when a party can show that it has been damaged as a result of the opposing party’s failure to timely complete the work, quantifying and proving those damages may be difficult. To guard against these intrinsic uncertainties on construction projects and disputes, parties often insert liquidated damages provisions into their construction contracts.

Contracting parties use liquidated damages provisions to quantify the consequences of a breach before it occurs, potentially saving time and expense in litigating the issue of damages. Such provisions are particularly useful when damages are uncertain in nature, uncertain in amount, or are immeasurable, which is often the case in many government contracts disputes.

Courts will typically enforce liquidated damages unless the amount of liquidated damages is not reasonably related to any probable damage which may follow a breach, or is so extravagant or so disproportionate to the loss that it constitutes a penalty instead of a means for the injured party to be compensated for its loss.

In federal government contract cases, when presented with a challenge to a liquidated damages clause, a reviewing court or board of contract appeals must judge the clause as of the time of making the contract and without regard to the amount of actual damages. The party challenging a liquidated damages clause – typically the contractor – bears the burden of proving that the clause is a penalty. The burden is a heavy one because when damages are uncertain or hard to measure, it naturally follows that it is difficult to conclude that a particular liquidated damages amount or rate is an unreasonable projection of what those damages might be. Because of this difficulty, it is generally improper for a court to inquire into the process that the contracting officer followed in arriving at the liquidated damages figure that was put forth in the solicitation and agreed to in the contract. Nevertheless, a court reviewing the contracting officer’s decision will sometime conduct this analysis as shown in the case below.

Case Illustration

In K-Con Bldg. Sys., Inc. v. United States, 97 Fed. Cl. 41 (2011), K-Con Building Systems entered into a contract with the Coast Guard for the design and construction of a prefabricated building to house a component repair shop at the Coast Guard Support Center in Elizabeth City, North Carolina. The contract contained the following liquidated damages provision:

If the Contractor fails to complete the work within the time specified in the contract, the Contractor shall pay liquidated damages to the Government in the amount of $551.00 for each calendar day of delay until the work is completed or accepted.

Throughout the project’s construction, the contractor failed to meet project deadlines and was eventually terminated by the government for default. Pursuant to the default clause, the government reserved the right to recover any excess costs incurred in completing the building, along with the right to assess liquidated damages. Consequently, the government assessed liquidated damages against the contractor.

The contractor filed suit, seeking to convert the default termination into a termination for the government’s convenience, and seeking remission of retained liquidated damages by the government. The contractor argued that the rate of the liquidated damages specified in the contract constituted an unenforceable penalty or, in the alternative, that it was entitled to a remission of liquidated damages due to an excusable delay.

In regard to the reasonableness of liquidated damages, the contractor argued that the government’s calculation of the liquidated damages rate was arbitrary and unsupported, and that some components comprising the liquidated damages, such as administrative costs, should not have been included. The contractor further argued that the process used by the government to
compute the liquidated damages rate was improper, thereby rendering the liquidated damages unenforceable. The Court of Federal Claims found that the contractor failed to meet its burden of showing that the liquidated damages were unreasonable at the time the contract was made. The court explained that so long as the liquidated damages rate was reasonable, the court could not inquire into the process that was used to arrive at the liquidated damages rate. In addition, the court explained that the contractor’s argument that certain components used in the computation of liquidated damages should not have been included or were arbitrary because they were not included in other contracts was irrelevant because the contractor had the burden to show that the component amount was improper as it related to the particular contract at issue.

In regard to remission of liquidated damages due to an excusable delay, the contractor argued that it was entitled to a finding of excusable delays because the delays for which it was responsible were concurrent with delays attributable to the government and that these concurrent delays could not be apportioned between the two parties. The court explained that federal law applicable to government contracts provides that the government cannot assess damages against a contractor for a failure to complete work under a contract if the delay in completing the work arises from unforeseeable causes, such as acts of the government or delays of subcontractors or suppliers that are beyond the control and without the fault or negligence of the contractor. In this case, however, the court held that the contractor failed to prove that the government’s delays were concurrent, which could in turn prevent the government from recovering liquidated damages from the contractor. As a result, the court upheld the liquidated damages provision and allowed the government to assess liquidated damages against the contractor.

**Practical Advice**

When it comes to the enforceability of liquidated damages provisions, the party challenging the liquidated damages provision has the burden of showing that these damages are unreasonable and that they constitute a penalty. Meeting this burden can be difficult. Therefore, parties should evaluate the reasonableness of liquidated damages provisions before they sign the contract. This includes reviewing the components comprising the liquidated damages and the methodology used to compute the liquidated damages rate. If the review of the components and the methodology used to compute the liquidated damages rate reveals that the liquidate damages are unreasonable, the rate should be changed before the contract is signed. Proving unreasonableness after the dispute has already arisen becomes more difficult.

If, however, a party must challenge liquidated damages after a dispute has arisen, the challenging party should focus on proving that the liquidated damages are unreasonable and that they constitute a penalty. Showing that the methodology used in computing the liquidated damages rate is incorrect, or that certain components should not comprise the liquidated damages, becomes irrelevant if it does not ultimately show that those liquidated damages are unreasonable.

Finally, contractors on public projects should remember that the government cannot assess liquidated damages against a contractor for delays if the delays in completing the work arise from unforeseeable causes, such as acts of the government or delays of subcontractors or suppliers that are beyond the control and without the fault or negligence of the contractor. In such instances, even if the liquidated damages rate is reasonable, the contractor can avoid paying liquidated damages if the government is responsible for such delays.