

SURETY TODAY PRESENTATION

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August 13, 2018

THE SURETY AND LIQUIDATED DAMAGES

A. Liquidated Damage Clauses Generally

Liquidated Damages are generally defined as a specific sum of money expressly stipulated by the parties to a contract, in advance, as the amount of damages to be recovered by one party for a breach of the agreement by the other. In a typical construction contract, the liquidated damages provision will establish a daily rate to be paid by the delaying party for each day beyond the specified completion date that the project is late. The daily rate for delay is designed to represent an estimate of the actual damages that would be suffered each day the obligee is denied beneficial use of the project. It typically includes some factor of consequential damage, such as lost profits and revenues, extended conditions, additional fees that might be incurred, etc. As I noted, such liquidated damage provisions are supposed to be used in circumstances where actual damages resulting from delay are difficult or impossible to anticipate and they are designed to represent the parties' reasonable estimate of such damages so that the parties can avoid efforts to attempt to prove such damages in the event of a subsequent delay.

B. Historical Perspective

Historically, under the common law, penalties and forfeitures were not favored by the courts. Because liquidated damage clauses fix an amount of damages in advance, courts often viewed such clauses as penalties or forfeiture and refused to enforce them. Later, courts began to realize that in circumstances when actual loss could not be easily calculated or proven, a

liquidated damage clause was a valid alternative. Indeed, the courts began to note that a liquidated damage clause can serve a useful purpose when it would be difficult to prove the amount of loss with the degree of certainty required by the law, because such a clause promotes efficiency by increasing certainty and by decreasing risk-exposure, proof problems, and litigation costs.

Because liquidated damage clauses constitute a contractual modification of the common law, courts addressing such clauses tended to follow the maxim that a clause in derogation of the common law must be strictly and narrowly construed. Balanced against that approach over time was the recognition that the principles of “freedom to contract” should apply and be enforced and the parties to a contract should be free to establish the measure of damages resulting from a breach of that contract. The United States Supreme Court commenting on liquidated damage clauses in the case of *U.S. v. Bethlehem Steel Co.*, 205 U.S. 105 (1907) observed:

The courts at one time seemed to be quite strong in their views and would scarcely admit that there ever was a valid contract providing for liquidated damages. Their tendency was to construe the language as a penalty, so that nothing but the actual damages sustained by the party aggrieved could be recovered. Subsequently, the courts became more tolerant of such provisions, and have now become strongly inclined to allow parties to make their own contracts, and to carry out their intentions, even when it would result in the recovery of an amount stated as liquidated damages, upon proof of the violation of the contract.

More recently, the Supreme Court of Minnesota observed that:

The modern trend is to look with candor, if not with favor, upon a contract provision for liquidated damages when entered into deliberately between parties who have equality of opportunity for understanding and insisting upon their rights, since an amicable adjustment in advance of difficult issues saves the time of courts, juries, parties, and witnesses and reduced the delay, uncertainty, and expense of litigation.

Gorco Const. Co. v. Stein, 256 Minn. 476 (1959).

Courts embracing the “freedom of contract” approach reason that liquidated damage clauses should be enforced because the issue of actual damages to be sustained due to delay is better left in the hands of the parties who are best able to estimate such damages and because contractors are presumed to have taken such clauses into consideration in pricing the contracts they accept. As the Supreme Court stated, “[t]he parties to a contract, with full understanding of the results of delay and, before the differences of interested views had arisen between them, were much more competent to justly determine what the amount of damages would be.” *Wise v. U.S.*, 249 U.S. 361, 367 (1919). In the construction context, a number of courts have held that damages resulting from the late completion of a construction project, by their nature, generally are difficult to ascertain. This presumption is particularly strong in public contracting where courts generally acknowledge the difficulty inherent in calculating the damage to the public caused when such projects are delayed. Thus, the loss of use of a public building for a period of time, traffic delays caused by roadwork, or the loss of educational services due to the delay in school construction are commonly deemed sufficiently intangible and incalculable to satisfy the use of liquidated damages.

Given the past from which liquidated damage clauses have arisen, when enforcement of a liquidated damage clause is at issue, the critical question, even today, still remains – is the amount of the stipulated damage an illegal penalty designed to punish rather than compensate. As a general rule, a liquidated damages clause will be deemed to be an unenforceable penalty if it is proven that: (1) there was an intent to deter or punish a contractor for breaching the contract, or (2) the stipulated amount was unreasonable in relation to foreseeable actual damages at the time of the contract. Thus, some courts hold that for a liquidated damage clause be valid: (1) the amount fixed as damages must be a reasonable forecast for the harm caused by the breach; and

(2) the harm that is caused by the breach must be of a kind difficult to accurately estimate. *Info. Sys. & Networks Corp. v. City of Kansas City, Mo.*, 147 F.3d 711, 714 (8th Cir. 1998).

C. The Surety's Exposure to Liquidated Damages

Liquidated damage clauses are common place in most construction contracts and are even part of the Uniform Commercial Code. *See* U.C.C. §2-718(1). The AIA A-312 Performance Bond (2010) provides for recovery of liquidated damages against the surety in certain circumstances in §7.3. There is a similar provision in the EJCDC C-610 Performance Bond (2103) at §7.3. Most courts have held that sureties are responsible for liquidated damages both directly and indirectly. Directly when the LD's are assessed against a defaulted principal or the surety through a takeover agreement and indirectly where the LD's were assessed against a general contractor by an owner and were then passed down by the general contractor to the bonded subcontractor.

Courts in at least two jurisdictions have declined to hold the surety responsible for liquidated damages unless the bond clearly identifies such liability. Pennsylvania law establishes that “[a] bond given pursuant to a contract incorporated in the bond will construed in the light of the terms of the contract and the attendant circumstances, but the obligation of a bond cannot be extended beyond the plain import of the words used.” *Peter J. Mascaro Co. v. Milonas*, 401 Pa. 632, 166 A.2d 15, 17 (1960). In *Downingtown Area School District v. International Fidelity Insurance Co.*, 769 A.2d 560, (Pa.Comm. Ct. 2001), appeal denied, 567 Pa. 731, 786 A.2d 991 (2001), a school district contracted to have an elementary school built. The contract provided that the bonded principal would be liable for liquidated damages for delay and other consequential losses. When the principal stopped work on the project, the school district formally declared it to be in default and sought delay damages, liquidated damages, and

attorneys' fees from the surety. The Court held that because the performance bond did not specifically obligate the insurance company to cover all claims arising under the construction contract, coverage was limited to the precise terms of the bond. Specifically, the school district could only recover the costs of completion of the project. The court noted that its decision was not affected by a clause incorporating the terms of contract into the performance bond because under Pennsylvania law such a clause only sets out the condition of the surety's liability rather than the scope of that liability. *See also Wise Investments, Inc. v. Bracy Contracting, Inc.*, 232 F. Supp. 2d 390, 402–03 (E.D. Pa. 2002). A similar approach and result was reached by a Louisiana court. *See also Jefferson Parish Consolidated Garbage District No. 1 v. Waste Management of Louisiana, L.L.C.*, 2010 WL 1731204 (E.D.La. April 28, 2010). Thus, as a threshold matter when a surety is addressing a claim for liquidated damages the surety should read the bond and check applicable law, including the jurisdiction's interpretation of the effect of incorporation by reference of the underlying contract into the bond.

D. Liquidated Damages Procedurally

The question of whether a liquidated damage clause will be enforced or rejected as a penalty is a question of law for the court to decide. In addition, the determination of whether a particular clause in a contract is to be construed as providing for liquidated damages, or as a penalty, depends on the facts and circumstances in each case. *Traylor v. Grafton*, 273 Md. 649, 667, 332 A.2d 651 (1975). Such determinations are typically well suited for summary judgment or motion to dismiss. The burden of proof as to the assessment of liquidated damages is initially on the party seeking the damages. They must show that the contract was not completed by the agreed upon completion date and that liquidated damages are properly due and owing. Once the initial burden of proof is met, the burden then shifts to the party opposing liquidated damages to

show that the liquidated damages are unreasonable, that the provision is an unenforceable penalty or some other defense.

In evaluating the reasonableness of a liquidated damages provision the question arises as to what time period to make the assessment – at the time of contract, at the time of breach or both. There is a split among the jurisdictions. A slim majority of jurisdictions appear to favor a “single look” approach, which tests the validity of the clause only as of the time of contract. That view gives deference to the bargain struck by the parties. Competing with that approach in an almost equal number of jurisdictions is the view that a “second look” as of the time of the breach to determine if the sum stipulated as liquidated damages is unreasonably and grossly disproportionate to the real damages from a breach. The surety will need to determine the approach taken in the applicable jurisdiction to address the issue. The more popular view is that the reasonableness of a liquidated damages clause should be determined as of the time the contract was executed, not with the benefit of hindsight.⁶ This view, sometimes referred to as the "prospective" or "single look" approach,⁷ requires only that the amount specified be a reasonable forecast or estimate of the damages expected or likely to flow from a breach of the contract, that is, that the appropriate determinant is whether the clause is reasonable compared to the anticipated, rather than the actual damages.⁸ As one court taking this position said:⁹ "The parties are not required to make the best estimation of damages, just one that is reasonable.... It is immaterial that the actual damages suffered are higher or lower than the amount specified in the clause."

E. Liquidated Damages and Actual Damages

The issue of actual damages as related to a liquidated damage provision arises in many forms. In most jurisdictions if the contract has a liquidated damage provision, the damaged party

will be precluded from recovering actual damages for delays and will be limited to the stipulated liquidated damages. This is true regardless of whether the ultimate actual damages were more than the liquidated damage amount. If the actual damages are less than the liquidated damage amount the issue will become by how much and whether such difference is grossly excessive or unreasonable. However, liquidated damages can be the measure of recovery even when there are no actual damages. In the *Bethlehem Steel* case the Supreme Court upheld the liquidated damage provision even though there were no damages. In that case the contract required the contractor to provide parts for weapons for the federal government. The contractor failed to meet the delivery deadline. However, during performance of the work, the war for which the weapons were needed ended and there was no longer any need for the weapons. Clearly, the government would have had a hard time quantifying damages in that scenario, but the Court held that the liquidated damage provision applied in such circumstance as it was the parties' bargain.

It is generally recognized that the liquidated damage provision is a substitute for actual damages and that the provision constitutes the damaged party's exclusive remedy for delay caused by events within the scope of the provision. There are some jurisdictions, however, where the courts have allowed recovery of actual damages for delays and liquidated damages for delays at the same time. Conceptually, this result makes no sense given the express purpose of a liquidated damage clause. In the circumstance where a general contractor is assessed liquidated damages by the owner and it flows those damages down to the responsible subcontractor and also seeks recovery of the general contractor's delay damages against this same responsible subcontractor, actual and liquidated damages may be properly recoverable. But in the absence of that scenario, allowing actual damages for delay and liquidated damages is wrong.

In one unusual case from the New York Appellate Court, without any real analysis and in an opinion which another New York Appellate Court subsequently refused to follow, the Court allowed recovery of liquidated damages and actual damages against a surety. *Int'l Fid. Ins. Co. v. Cty. of Chautauqua*, 667 N.Y.S.2d 172, 173–74 (1997). In that case the County entered into a contract with the principal to construct an addition to the County Jail. Subsequently, the County declared the principal to be in default and demanded that the surety complete the work pursuant to the performance bond. The County and the surety entered into a Takeover Agreement and the surety completed the work approximately a year and a half after the deadline established by the original contract. The County paid the surety \$585,250 for completion of the work, but retained \$270,554.40 as compensation for the expenses of delay and completion, the costs of correcting the principal's defective work, liquidated damages for delay of \$100 per day, and attorney's fees. The surety sued the County for breach of contract, seeking the unpaid contract balance of \$270,554.40. The County responded with a counterclaim seeking an additional \$301,402.80 in lost revenues attributable to the County's inability, as a result of the alleged delay in completing the work, to house Federal prisoners in the new jail. The surety moved for partial summary judgment dismissing the counterclaim on the ground that liquidated damages were the County's sole remedy for delay. The trial court granted the motion. The appellate court reversed. The Court acknowledged that generally, where an owner and contractor have agreed that the owner will receive liquidated damages because of the contractor's delay in completing the project, that provision will be enforced as the owner's exclusive remedy, thus precluding any claim by the owner for actual damages. However, the Court held that liquidated damages were not the County's exclusive remedy in this case and that the County may recover lost income and other actual damages stemming from the surety's delay in completing the project.

The Court explained that the County's counterclaim against the bonding company arises out of the performance bond, not the original contract. Under the terms of the bond, the Court believed that the surety assumed the contractual obligations agreed to by its principal but also assumed obligations of its own, including the obligation to complete the contract “promptly” and, in the event of a breach, to pay “[a]dditional legal, design professional and *delay costs* resulting from the principal’s Default, and resulting from the actions or failure to act of the Surety”. The Court concluded that the County's claim for actual damages was “impliedly reserved” by the language of the Takeover Agreement. The Court clearly misinterpreted the language of the bond. The provision relied upon by the Court was for the surety to “promptly” make a choice under the performance options of the bond and the damages for delay applied if the bond was breached. There was no discussion in the opinion as to whether the surety breached the bond or unreasonably delayed in completing the work.

While the general rule is that liquidated damages and actual damages are mutually exclusive, it is important to keep in mind that actual damages may still be recovered for breaches other than those contemplated by the liquidated damages provision. For example, it would be proper for an obligee to recover liquidated damages and damages to repair defective work. This is because an award of liquidated damages typically precludes only the recovery of actual damages for the delayed performance.

F. Substantial Completion

Most construction contracts expressly state the date or circumstances which will end the assessment of liquidated damages. In most jurisdictions, courts will not impose liquidated damages for delay after the date of substantial completion unless the contract provides otherwise.

Thus, a finding of substantial completion typically will toll the assessment of liquidated damages.

II. DEFENSES TO LIQUIDATED DAMAGE CLAIMS

A. The Liquidated Damage Clause is a Penalty

Owing in part to the still lingering mistrust of stipulated damage clauses there are seemingly innumerable ways to attack a liquidated damage clause as a penalty. Accordingly, the first line of defense for any surety is to evaluate whether the clause is an unenforceable penalty. Commentators have noted that “[t]he cases nullifying liquidated damages as penalties almost without exception rely upon a substantive assessment of whether the liquidated damage amounts are a reasonable approximation of actual damages.” Thus, exploring the method of how the obligee determined the liquidated damage amount can be critical in determining whether the clause will be enforceable. Was the daily rate the same number the obligee always uses regardless of the nature of the project – that would be a penalty. The damage amount must be a fair and reasonable estimate of probable damages on the specific project. Was the daily rate determined by coming up with a number that would scare the contractor or spur the contractor into completing on time – that’s a penalty. Was there no effort at all to estimate damages and just a random daily rate was used – penalty.

Aside from the method of determining the amount of liquidated damages, some courts hold that where the amount is grossly in excess of actual damages, the clause could be a penalty. Where the damage sum is unreasonably large, such as in one case where the amount was 1/3 of the total contract price, such amount was a penalty. In Virginia and New York, a liquidated damage clause will be deemed a penalty if the actual damages resulting from delay are in fact susceptible of definite measurement. Further, liquidated damages will not be allowed where the

contractual language and attendant circumstances show that the contract also provides for the full recovery of actual damages, because liquidated and actual damages are mutually exclusive remedies.

When you look into the case law on liquidated damages, you will see that the cases are all over the map and again probably reveal the natural bias of the particular court in favor or against such clauses. For example, in one case the court upheld a \$43,000 per day liquidated damage clause for delay in completing an odor reduction system for a waste water treatment plant. Something just doesn't smell right there.

Of course, with all of these defenses I am discussing, the age-old adage "be careful, because you may get what you wish for" applies. If you raise a successful defense and the liquidated damage clause is deemed unenforceable as a penalty, the obligee will then be able to pursue its actual damages.

B. Abandonment

Recently, I have had a run of cases where the principal just closed its doors. In several instances it was the result of the bank sweeping all the operating funds out of the principal's and indemnitor's accounts. In those cases, the principal has simply abandoned the bonded projects. With respect to enforcement of liquidated damage clauses, abandonment could actually be a good thing. In some cases, courts have held that where the contractor completely abandons the project the liquidated damage clause is not enforceable. In those cases, the courts have found that such provisions did not contemplate total abandonment. Similarly, one commentator observed that a liquidated damages provision must be construed so as to not "go on operating forever," as it would then "in fact operate as a penalty." Upon abandonment other courts have refused to enforce liquidated damage clauses because once the contractor has left the project it

no longer has control over the completion of the work. However, other courts have held that, when a contractor has abandoned a project, operation of a *per diem* liquidated damages provision is limited to “the time reasonably necessary for the plaintiff to procure completion of the agreed performance by a substitute contractor or by the plaintiff’s own efforts.” If you are faced with an abandonment situation on a project with liquidated damages you should determine if the applicable jurisdiction alters enforcement of the clause.

C. Excusable Delay

Excusable delay is delay to the critical path outside of the control of both the contracting parties. The parties share this risk by bearing their respective costs incurred because of such delay, but granting each other time extensions to cover the extended duration resulting from the delay. In other words, one receives time but not money for excusable delays. A finding of excusable delay precludes the obligee from assessing liquidated damages for that period of delay.

D. Obligee Caused Delays

Generally, a liquidated damages clause is not enforceable if the delay is due to the fault of the party claiming the benefit of the provision. Courts routinely recognize that “where one seeking to enforce a provision for liquidated damages is responsible for the failure of performance, or has contributed in part to it, the provision will not be enforced.” *S.O.G.-San Ore-Gardner v. Missouri Pac. R. Co.*, 658 F.2d 562, 570 (8th Cir. 1981) (project owner’s action causing delays to completion of contract barred recovery of liquidated damages)(citing cases); *Schmulbach v. Caldwell*, 215 F. 70, 71 (4th Cir. 1914) (contractor not liable for liquidated damages for delays caused by project owner); *Seubert Excavators, Inc. v. Eucon Corp.*, 871 P.2d 826, 831-32 (Idaho 1994) (contractor delayed project completion by failing to timely deliver rock crusher and was barred from recovering liquidated damages against sub-contractor for

delayed performance). Thus, because the obligee's actions prevented the principal from performing the contract by the original completion date, the obligee will be barred from recovering liquidated damages for the time period in which it delayed performance of the contract.

E. Concurrent Delays

Where the obligee is responsible for concurrent delay at the same time that the principal was causing delay, the delays will offset each other and the obligee will not be entitled to assert liquidated damages. *See Avedon Corp. v. United States*, 15 Cl. Ct. 648, 653 (1988) (recognizing concurrent delays "offset" contracting parties' rights to compensable damages during the concurrent delay period). The rule is well settled that in cases where the delays have been caused by both parties to the contract and completion of the contract has thereby been extended beyond the time fixed, the obligation for liquidated damages is annulled and the courts will not attempt to apportion such delays between the parties and hold the contractor liable in damages for any portion of the delay.

F. Waiver/Estoppel

The obligee may waive its right to enforce a liquidated damage provision if it knowingly and voluntarily either expressly waives the right or through its actions and conduct demonstrates either an intent to relinquish its right to liquidated damages and/or its conduct was inconsistent with an intention to enforce that right. Waiver may result from a variety of circumstances, such as an obligee's: (1) encouragement of continued performance after expiration of the contract time without objection and without invoking the liquidated damages clause; (2) direction to the contractor to perform extra work after the scheduled completion date; (3) failure to place the contractor in default; or (4) failure to claim entitlement to liquidated damages prior to making

final payment. In some cases, the waiver could be express as where the contract provides that the making of final payment waives any claims of the obligee, which can include liquidated damage claims.

III. CONCLUSION

Surety's frequently face liquidated damage claims and typically the claim is made as an off-set to the contract balance by the obligee as opposed to the surety actually writing a check. The best approach is to attempt to bargain away or reduce the liquidated damages at the time the surety is negotiating its performance and deciding whether to takeover, tender, buy out, etc. If agreement cannot be reached with the obligee as we discussed there are a number of defenses that can be explored.