Law and Practice
Contractor Marketing — Penalty Clauses

January/February 2001

Written By:

Mark C. Friedlander
t 312.258.5546
mfriedlander@schiffhardin.com

SCHIFF HARDIN LLP
6600 Sears Tower
Chicago, Illinois 60606

t 312.258.5500
f 312.258.5600

www.schiffhardin.com

Staff Exhibit No. KCPL 313
Date 3/3/11 Reporter SMB
File No. ER-2010-0355 & ER-2010-0356

The title of this article is a misnomer. So-called "penalty clauses," which require the contractor to pay the owner a certain sum for each day that the project is late, are not really penalties at all — at least if they are properly drafted.

The proper legal name for penalty clauses is "liquidated damages." Liquidated damages are merely an agreement between the parties as to what damages will be assessed for late completion, so that neither party has to prove what the actual damages are (or are not). A typical liquidated damages clause reads something like the following:

> *"For each calendar day beyond the scheduled date of Substantial Completion that the Project has not achieved Substantial Completion, the Contractor shall pay to the Owner as liquidated damages the sum of $_____."*

Note that it is usually appropriate to measure liquidated damages to the date of Substantial Completion, not Final Completion. At Substantial Completion, the Project by definition is sufficiently ready for' the owner to occupy and make beneficial: use of it. Accordingly, any damages that the owner suffers from not being able to use the project typically end when the project is Substantially Complete.

Many construction industry participants mistakenly consider a liquidated damages provision to be a penalty clause because it often functions as an incentive for the contractor to complete the project on time. That is not the legal interpretation, however. The courts generally deem it improper and unenforceable for parties to a contract to agree to impose penalties on each other that are unrelated to the actual damages that they incur. Penalties, like fines or forfeitures, may be imposed only by the courts or by other representatives of the government, after due process of law.

But parties to a construction contract may agree to pay liquidated damages. To be valid and enforceable, the liquidated damages provision must be a reasonable estimate, as of the point in time at which the contract is signed, of the actual damages that the owner would suffer from late completion. Actually, there are three requirements for a valid liquidated damages clause: (i) that it is likely that the owner would suffer some damages; (ii) that the owner's damages are not capable of precise calculation; and (iii) at the point of time in which the contract is agreed upon, the liquidated damages sum is a reasonable approximation of the owner's likely actual damages. The first two requirements are met in virtually every construction project. Thus, many liquidated damages clauses begin with a preamble that looks something like the following:

"The parties agree that it is virtually certain that the owner would be damaged if the project is completed late and that the precise amount of such damages is difficult or impossible to calculate. Accordingly, the parties agree to impose liquidated damages as follows..."

Many contractors erroneously fear liquidated damages provisions, when in reality they can work to a contractor's advantage. The liquidated damages sum represents the maximum as well as the minimum that an owner can recover for delay damages. Even if an owner's actual delay damages are much greater, the owner's recovery is limited to the liquidated amount. Courts do not permit owners to recover actual delay damages in addition to liquidated damages. A relatively low liquidated damages sum acts almost like a limitation of liability provision on behalf of the contractor.

However, liquidated damages may be recoverable even if the owner has not suffered any real damages. In a famous case arising from the construction of the interstate highway system around Chicago in the 1950s,* the City of Chicago attempted to enforce a liquidated damages clause against Bethlehem Steel for late delivery of structural steel. Bethlehem Steel defended on the grounds that any time lost from the late delivery of structural steel. Bethlehem Steel defended on the grounds that any time lost from the late delivery was made up by subsequent contractors so that the expressway system opened on time. Thus, the City suffered no actual damages.

The Seventh Circuit Court of Appeals held that Chicago was entitled to liquidated damages regardless of having not suffered any actual damages. It noted that the point in time from which a liquidated damages clause is evaluated is when the contract is signed, and at that time the parties were perfectly justified in believing that late delivery would result in project delays. Accordingly, after finding the liquidated damages sum to have been a reasonable approximation of the expected actual damages, the Court ordered Bethlehem Steel to pay the liquidated damages.

There is a popular misconception that liquidated damages clauses are only enforceable if there is a corresponding bonus clause for early completion. While the existence of a bonus provision lends great credibility to the owner's position that it would in fact suffer damages if the project is delayed, it is not necessary that there be a bonus provision

* *Bethlehem Steel Corp. v. City of Chicago*, 350 F.2d 649 (7th Cir. 1965).

File No.

SCHIFFHARDIN LLP

to render the liquidated damages clause valid and enforceable. And if there is a bonus provision, the amount of the daily bonus does not need to equal or even relate to the liquidated damages amount.

Delay calculations do not have to be measured in "days." They may be measured in hours, or even minutes. Particularly in road or other transportation projects, where the goal may be to complete construction and remove barricades prior to the onset of rush hour, the parties may agree to assess liquidated damages for delay in smaller than usual increments of time.

Another common misconception is that contracts that lack liquidated damages provisions do not impose delay damages against the contractor. However, an owner is generally entitled to delay damages for contractor-caused delays regardless of whether or not there is a liquidated damages clause in the contract. The liquidated damages provision simply avoids the need to prove the extent of real damages. Without such a clause, the owner is entitled to recover whatever actual damages the owner can prove.

SCHIFF HARDIN LLP

About the Author

Mark C. Friedlander is a partner in the Construction Law Group at the law firm of Schiff Hardin LLP. He obtained his B.A. from the University of Michigan in 1978 and his J.D. from Harvard Law School in 1981. He is currently an adjunct professor at the University of Illinois at Chicago School of Architecture and a lecturer at Northwestern University's Engineering School, and had lectured at the Illinois Institute of Technology School of Civil Engineering from 1987-89, at the Engineering School of the University of Wisconsin in 1988 and 1990, and the Architecture School of the Georgia Institute of Technology in 1997-98. Mr. Friedlander concentrates his practice in construction law and litigation with particular emphasis on design-build methods of project delivery.

About Schiff Hardin LLP

Schiff Hardin LLP was founded in 1864, and we are Chicago's oldest large law firm. In the past 140 years we have grown to more than 325 attorneys, with additional offices in New York, New York; Washington, D.C.; Lake Forest, Illinois; Atlanta, Georgia; and Dublin, Ireland.

As a general practice firm with local, regional, national, and international clients, Schiff Hardin has significant experience in most areas of the law. For more information visit our Web site at www.schiffhardin.com.

This article has been prepared for general information. It is not meant to provide legal advice with respect to any specific matter. The reader should consult a lawyer regarding specific legal advice.

Available on the Schiff Hardin Web site at http://www.schiffhardin.com/media/news/media.140.pdf.