LIQUIDATED DAMAGES:
AN APPROACH TO ADDRESSING
PERFORMANCE BREACHES IN CONTRACTS

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Abstract

This paper will define and explain liquidated damages, a contractually correct method of assuring enforceability and damage recovery in the event of a contract breach. This paper will further point out that failure to use liquidated damage clauses could result in litigation—with litigation’s attendant costs, delays, and sometimes unexpected results.

Introduction

The costs, both in time and financial resources, to litigate appropriate damages for contract breaches can be significant. "Americans spend $80 billion a year on direct litigation costs and higher insurance premiums," said Vice-President Dan Quayle (Cuneo et al., 1992). Properly executed liquidated damage provisions may decrease litigation expenses by reducing the need to go to court to determine damages. Engineers must be careful where drafting these provisions not to label them "penalties." As this paper will illustrate, merely labelling damages as "penalties" instead of liquidated damages may cause the courts to invalidate the provisions. Further, this paper will explain why identifying liquidated damages in the contract is important to all the signatories to the contract. (This paper is limited to contracts subject to US law.)

Background

The fact that engineers are not familiar with the concept of liquidated damages is understandable. Liquidated damage recovery has long been a source of confusion for courts and private parties alike (Ferris, 1982). In Bianell v. Gould: "Whoever framed this agreement does not appear to have any very clear idea of the distinction between a penalty and liquidated damages."

In the decision of Giesecke v. Cullerton:

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, and that each case must depend upon its own peculiar and attendant circumstances, and that therefore general rules of law on this subject are very often of very little practical significance.

Legal Considerations

A contract is a legally enforceable promise that has five elements: offer,
acceptance, consideration, capacity, and legality of purpose (Corley et al., 1990).
This paper will focus on an element of consideration; that is, the part of the contract in which the parties agree on the terms regarding the value of goods and services being exchanged.

Contract law is used to judge contract disputes. Most of this body of law comes from common law, which is the sum of court decisions in prior cases. Another source of much contract law is the Uniform Commercial Code (UCC), which deals specifically with the sale of tangible property (i.e., goods) such as gas turbines. The purpose of the UCC is to have common law across state lines. The UCC in whole or in part may be adopted by a state legislature, in which case the UCC supersedes prior common law decisions. The hierarchy of law means that law that is legislated takes precedence over common law (Corley et al., 1990). Thus, cases decided before the adoption of the UCC may no longer be considered precedent, since the UCC supersedes any part of this body of law that is not consistent with the UCC. In fact, all states except Louisiana (Corley et al., 1990) have adopted the UCC paragraphs relating to liquidated damages.

Within the legal system, there are three rules to determine the meaning of words used in law: plain or usual meaning, technical meaning for technical words, and words taking meaning from the context in which they are used. For example, the word "rose" would normally be interpreted as a flower. However, if it were followed by the word "wine," it would instead be interpreted to mean a type of wine. The meaning of words is very important because in the judicial system, statutes (laws) concerning remedies for the injured parties are liberally construed (Corley et al., 1990). This means that doubts about meaning are usually resolved in favor of the injured party. The UCC states in paragraph 1-106 (West, 1987):

The remedies provided by this act shall be liberally administered to the end that the aggrieved may be put in as good a position as if the other party had fully performed but neither consequential or special nor penal damages may be had except as specifically provided in this Act or by other rule.

Another rule in contract construction is that the terms will be interpreted most favorably for the nondrafting party.

When an obligation of the contract is not achieved, the party that failed to perform is considered to be in breach of the contract. Specified amounts for damages in the event of a breach can be defined in the contract as "liquidated damages." All other alternatives to recovering damages occur after a breach, when judgment may be clouded by emotional consideration of the situation. After-the-fact settlements will be more expensive for all parties. There is also the probability that at least one, if not both, parties will be dissatisfied with the outcome.

The after-the-breach solutions include two general categories:

1. In court:
   a. Rescission- When the contract is voidable, the affected party asks the court for a rescission, which requires each party to return what it got from the other party. This solution is not a likely outcome for turbomachinery applications.
   b. Specific performance- Court-ordered performance when the subject of the contract is unique. This outcome is also unlikely for turbomachinery applications.
   c. One of three types of damage awards-
      c1. Nominal- A small amount, usually $1, for a breach which causes no financial injury to the plaintiff. This is not a likely potential outcome in turbomachinery applications because ideally users and suppliers can reach agreement before the dispute gets to court.
      c2. Compensatory- An amount the court determines puts the plaintiff in the
same position as if the contract had been performed. The amount can include lost profits and the cost of getting substitute performance. This is a potential outcome for turbomachinery disputes.

c3. Consequential- An amount the court determines from unusual losses which the parties knew would result from breach of the contract. This is a potential outcome for turbomachinery applications; however, most contracts also contain a limitation of liability clause which limits (or excludes) consequential damages. Note that the courts can award both compensatory and consequential damages for a single case.

2. Out of court:

a. Negotiated settlement- A voluntary agreement between the parties themselves. This has been the most common method of resolution for all applications (including turbomachinery) in the past.

b. Arbitration- An agreement by the parties to abide by the decision of a neutral third party, or parties. This is a viable option if the adversaries can agree on neutral third parties.

c. More recently, rent-a-judge and early neutral evaluation, also known as alternative dispute resolution (ADR), (Corley et al., 1990; Cuneo et al., 1992) methods have been developed to attempt to resolve conflict before they reach court. These solutions may be appropriate to turbomachinery disputes if both parties are willing.

The UCC paragraph 2-718 (West, 1987) defines liquidated damages. It states:

Damages for breach by either party may be liquidated in the agreement but only at an amount which is reasonable in light of the anticipated or actual harm caused by the breach, the difficulties of proof of loss, and the inconvenience or nonfeasibility of otherwise obtaining an adequate remedy. A term fixing unreasonably large liquidated damages is void as a penalty.

This means that the contracting parties can agree upon how much a breach will affect the nonbreaching party. Courts will enforce this provision as long as it is not held to be an unreasonably high penalty for nonperformance.

From a historical perspective, the landmark Supreme Court case upholding liquidated damages is United States v. Bethlehem Steel. In this case, the court ruled that even though there were no actual damages to the US Government, Bethlehem Steel was still required to pay the damages stipulated in the contract. In so ruling, the court stressed freedom to contract (Ferris, 1982). This means that the parties are free to include in the contract items they agree are important and need to be identified. It also means that courts are very reluctant to reform the contract provisions which are the result of arms-length negotiations.

In the case of Powers v. Grinnell Corp., Powers alleged violation of the Age Discrimination in Employment Act (ADEA). This act specifically provides for liquidated damages equal to back pay and benefits. In making its decision, the court liberally interpreted and held: "Congress also intended liquidated damages to serve as compensation for a discharged employee's nonpecuniary losses arising from the employer's willful misconduct." Furthermore, it stated: "The ADEA ... does not provide remedies of a punitive nature." This case illustrates the concept of liberal interpretation, since ADEA does not specifically refer to nonpecuniary losses.

The Business Lawyer (Hoffman, 1989) noted in the context of a construction contract: "A liquidated damage constitutes an estimate by the contractor and project sponsor of the ramifications of late or deficient performance by the contractor on the project." Further, The Business Lawyer article on Project Financing (Hoffman, 1989) states:

The nature of a liquidated damages clause is to avoid calculation of
damages following a dispute. These clauses are particularly useful in project financing because of the need for predictable results after a failure to perform.

Liquidated damage clauses are optional and not necessarily an exclusive remedy (Ralston Purina v. Hartford Accident & Indem. Co.). However, such clauses can play an important part in resolving disputes and preventing litigation (Sheppard, 1989). While the clauses may be optional, New York State law requires a liquidated damages clause in all contracts by boards of education of cities over 125,000 persons (New York Consolidated Laws Service, 1992). If the payment specified is larger than the economic consequences to the nonbreaching party, the courts will generally hold that the payment is a penalty and will not enforce the payment (Rubin, 1981). In the case of I.A.M. National Pension Fund Benefit Plan A et al. v. Monal Manufacturing Co., Inc., the court ruled:

Further, under common law liquidated damages must represent a genuine pre-estimate by the parties of the extent of injury that will be caused by a future breach, Corbin paragraph 1159-60, and will not be enforced if intended by the parties to secure performance by imposing a penalty in excess of the actual loss likely to be sustained.

For a litigant to challenge a liquidated damage clause, the litigant must assert and prove that the liquidated damage acts as a penalty (Weisfield, 1990). The case of California and Hawaii Sugar (C&H) v. Sunship Corp. concerns a contract for Sunship to build a barge that would be attached to a tug being built by Halter Marine for C&H Sugar. At the time of signing, it was assumed that the tug would be ready in time to be attached to the barge, which incidentally was not the case. Sunship was late in delivering the barge. C&H attempted to collect the contractually stipulated liquidated damages for the late delivery. Sunship refused to pay and tried to persuade the court that the identified liquidated damages provided for in the contract were "penalties, not to be enforced by the court." Sunship further stated: "Unconnected, the barge was worse than useless—it was an expensive liability." The court stated (1) that C&H and Sunship reached the agreement that $17,000 a day was the reasonable measure of loss C&H would suffer if the barge were not ready and (2) that the appropriate damage was as stated in the contract. The court based this decision in part on the prior decision in Belmont Industries v. Rechtel Corp., which determined that the governing statutes provide that liquidated damages are reasonable in light of the anticipated or actual harm.

Finally, the process of determining liquidated damages can be difficult. Hartzler (1968) observed that excessive liquidated damages may introduce a deterrent to the very contract-making behavior we are trying to encourage. Writing contracts that avoid litigation is the behavior we should be encouraging (Clarkson et al., 1978).

**Costs**

The cost of litigation is enormous. Judge Learned Hand once said, "As a litigant I should dread lawsuits beyond almost anything short of sickness and death" (Henry, 1985). Vice-President Quayle said that legal costs in the US reach $300 billion a year. These costs are also making US firms less competitive worldwide (Cuneo et al., 1992). A Business Week/Harris Poll (Cuneo et al., 1992) of 400 corporate executives taken between January 27-Febuary 11, 1992 found:

- 89% said the high cost of defending and protecting the company was having an impact on their business.
- 79% said juries hand out excessive awards.
- 62% said the US civil justice system hampers competitiveness.

out-of-court settlement is a clear example of how much a contract breach case might cost. The subject of the action was the unexpected shutdown of the Peach Bottom Nuclear Plant. J. Durham, a Philadelphia Electric executive, said in announcing the agreement: "Philadelphia Electric estimated savings of between $5 and $10 million in litigation costs." Durham went on to say that "all litigation is unproductive overhead."

It could be argued that including a liquidated damages clause might encourage litigation since the defendant would not like to pay the stipulated damage. The preferred position is that these clauses provide additional incentive for the supplier to perform. Furthermore, as we have seen, courts are reluctant to change agreements entered into in good faith by two parties. Therefore, in summary, having an enforceable liquidated damages clause in the contract will generally avoid litigation. Having remedies in the contract so that each party knows the outcome in the event of a breach is in all the parties' best interest.

**Application to Turbomachinery**

Liquidated damage provisions can be used in turbomachinery contracts between users and suppliers. In such cases, the liquidated damages clauses are agreements by which parties stipulate specified levels of compensations to be awarded in the event of a breach. Liquidated damage clauses help ensure adequate relief in the event of broken promises by allocating business risks before the contract is signed. The clauses appear to be an efficient means of precluding litigation or of resolving conflict in the event of a dispute. For example, in the Enron Power Enterprise Corp. (Enron, 1990) testimony to the Federal Energy Regulatory Commission (FERC), Enron proposed to sell power to New England Power (NEPCO) from a powerplant Enron proposed to build. The agreement between Enron and NEPCO provided NEPCO with the right to terminate the contract and receive liquidated damages. The damage was defined as any increased power supply cost to NEPCO if Enron were in default. This example is particularly interesting because the damage was not a specific amount but rather a clearly defined cost that could be calculated in the event of a breach.

The most obvious application of liquidated damages is agreement by the parties on damages for late delivery. Using the logic from C&H Sugar v. Sunship, an appropriate formulation for delivery delay would be to identify the damage on a dollars-per-day basis, $100 per day beyond the contract delivery date.

Another application for liquidated damages would be performance, i.e., power output and/or thermal efficiency. In this case, dollars per percent of output or thermal efficiency shortfall would be an appropriate basis. This clause could be more specific, i.e., identifying the damages as, say, $5 per kilowatt shortfall in output. Similarly, a specific damage of, say, $5 could be applied for each 100 BTUs above the guaranteed heat rate. Liquidated damage clauses could be constructed to cover exhaust emissions. In the event that the manufacturer does not achieve the stipulated emissions levels identified in the contract (which are assumed to be no lower than the permit levels), the clause would be activated. Damages should be defined as dollars per quantity (for example, ppm, ton/day, etc.) of emission over the guaranteed level. With the advent of tradable permits, the liquidated damage solution might be the most cost-effective overall solution to a situation where emissions are higher than guaranteed.

Another type of performance that can be addressed is availability. A damage based on a dollar amount per hour unavailable above a certain threshold would be acceptable. This type of liquidated damage clause must be constructed very carefully such that only the appropriate equipment is charged. This type of clause has been incorporated into lease engine contracts. In these cases, the supplier stipulates the dollar amount of damages they are willing to accept if delivery of a lease engine is delayed beyond a predetermined amount of time, i.e., $100 per hour commencing with the 97th hour after notification.
Note that if several types of performance are being identified for liquidated damages, separate damage schedules for each potential breach should be identified (Sheppard, 1989). The liquidated damages should also be commensurate with the gravity of the breach to which they apply (Weisfield, 1990). It is incumbent on the party suffering the injury to try to mitigate the damage incurred. In all cases, the terms should be in accordance with UCC paragraph 2-718.

Advantages of Liquidated Damages

Our society continues to become more and more litigious. The number of cases in civil court has soared 300% since 1960 (Cuneo et al., 1992). This increase is exacerbated by an already overloaded and still expanding criminal case backlog. Further, criminal cases have priority over civil actions in the judicial system. This means that the ever-growing backlog of cases will result in further delays and additional costs for those parties choosing the courts as their course of action. Going through the court system also delays receipt of the damages that are ultimately obtained.

Pursuing a court solution is not necessarily in either party's best interest. The Wall Street Journal (1992) article cited previously quoted J. Durham of Philadelphia Electric as saying: "Through the courts you may get a legal settlement, but you may still have a business problem." Durham continued: "We still have a long term business relationship to foster. Being adversaries in court does not provide a positive image for companies trying to foster long term relationships." The article also quoted James Henry of the Center for Public Resources as follows: "In a courtroom it's a win-lose proposition."

Because of the financial pressure all organizations are under, it is likely that contracts of the future will increasingly specify liquidated damage provisions. The concept of liquidated damages provides a means for all parties (1) to know a-priori the consequences of a breach; (2) to receive timely compensation; and (3) to avoid the costs, delays, and negative publicity of court appearances.

Conclusion

Staying out of court in spite of contract breaches can be accomplished by using appropriately drafted liquidated damage provisions in the contract. The elements of a properly constructed liquidated damages clause are as follows:

- The remedies must be identified as damages, not as penalties.
- The damages identified must be reasonable and bear direct correlation to the actual amount of damages anticipated to be incurred.
- Appropriate damages must be set for each different type of breach identified.

If the liquidated damage clause is properly constructed, then litigation and its attendant costs, delays, and uncertainties can be avoided. As Abraham Lincoln said (Henry, 1985):

Discourage litigation. Persuade your neighbors to compromise whenever you can. Point out to them how the nominal winner is often a real loser—in fees, expenses, and waste of time.

Properly constructed liquidated damage provisions, not penalties, provide an opportunity to accomplish what Lincoln encouraged. The objective of writing an effective contract is the avoidance of litigation.
REFERENCES


Court Cases


