Contracts Tea no. 4 (June 2011)

South Carolina

Does a sliding scale always save a liquidated damage clause from being a penalty? Probably yes, but comply with industry standard in choosing the scale.

As we know, a liquidated damage clause is a clause that fixes the amount of damages that the non-breaching party can recover in case of breach. Historically courts have strictly examined liquidated damages to determine whether they amount to a penalty. In recent years courts have been more receptive to liquidated damage clauses because they have appreciated that they have the advantage of eliminating the problem of quantification of damage and of specifying parties' expectation interest. Therefore current law recognizes the enforceability of liquidated damages. Nonetheless a court can invalidate such a clause when it finds it to be a penalty.

The Restatement (Second) of Contracts § 356 (Liquidated Damages and Penalties) provides:

> (1) Damages for breach by either party may be liquidated in the agreement but only at an amount that is reasonable in the light of the anticipated or actual loss caused by the breach and the difficulties of proof of loss. A term fixing unreasonably large liquidated damages is unenforceable on grounds of public policy as a penalty.
> (2) A term in a bond providing for an amount of money as a penalty for non-occurrence of the condition of the bond is unenforceable on grounds of public policy to the extent that the amount exceeds the loss caused by such non-occurrence.

The South Carolina Court of Appeals has recently decided a case in which liquidated damages were at issue. *ERIE Ins. Co. v. The Winter Constr. Co.*, No. 4841.

Reduced to the essentials, the facts are as follows: after Winter Construction Company ("Winter") had been awarded the construction contract for a high school in Greenville, Winter had agreed with Fountain Electric ("Subcontractor") that Subcontractor would perform the electrical work in the project ("Subcontract"). Winter required Subcontractor to provide payments and performance bonds for its work from a surety acceptable to Winter. This surety was *ERIE Ins. Co (*"Erie"). The Subcontract included the damages provision that follows:

> If SUBCONTRACTOR fails to cure an event of default within seventy-two (72) hours after receipt of written notice of default by WINTER to SUBCONTRACTOR, WINTER may, without prejudice to any of [its] other rights or remedies, terminate the employment of SUBCONTRACTOR and [. . .] WINTER shall be entitled to charge all reasonable costs incurred in this regard (including attorney['s] fees) plus an allowance for administrative burden equal to fifteen percent (15%) to the account of SUBCONTRACTOR.

Subcontractor defaulted and Winter was forced to hire another subcontractor. After its default, Subcontractor as required by the terms of its bond agreement with Erie, assigned all of its rights under the Subcontract to Erie, including the right of payment for all contract balances owed to Subcontractor. Erie demanded Winter the payment of the remaining balance. Winter withdrew the money that according to its calculation was owed pursuant to the damage clause. Erie sued Winter for breach of contract. Among other things, Erie contended that the liquidated damages provision constituted an unenforceable penalty. Both parties moved for summary judgment. The trial court ordered summary judgment in favor of Erie, ruling that the damage clause in the Subcontract was an unenforceable penalty. The Court of Appeals reversed stating that

> The dispositive test on whether a provision in a contract is for liquidated damages or is an unenforceable penalty was set forth by our supreme court in *Tate v. LeMaster:* "Implicit in the meaning of 'liquidated damages' is the idea

> of compensation; in that of 'penalty,' the idea of punishment. Thus, where the sum stipulated is reasonably intended by the parties as the predetermined measure of compensation for actual damages that might be sustained by reason of nonperformance, the stipulation is for liquidated damages; and where the stipulation is not based upon actual damages in the contemplation of the parties, but is intended to provide punishment for breach of the contract, the sum stipulated is a penalty." 99 S.E.2d 39, 45-46 (1957) . . . Moreover, "[w]hether such a stipulation is one for liquidated damages or for a penalty is . . . primarily a matter of the intention of the parties." *Tate*, 99 S.E.2d at 45.

In particular, the Court of Appeals found that the meaning of the clause was clear and unambiguous (i.e. the stipulated sum was one for liquidated damages) and that Subcontractor was not an unsophisticated party. At that point the only question was the application of the *Tate* test: whether the clause was "reasonably intended by the parties as the predetermined measure of compensation for actual damages that might be sustained by reason of nonperformance . . . "(Tate, 99 S.E.2d at 46).

The determination has to be done looking at the whole contract and at the contract subject-matter, evaluating the ease or difficulty in measuring the damages resulting from breach, and considering the magnitude of the stipulated sum ("not only as compared with the value of the subject of the contract, but in proportion to the probable consequences of the breach.")

In this case, the Court found that: (1) Winter and Subcontractor might have reasonably anticipated that Winter's damages in case of breach would have been difficult to ascertain because of the nature of Subcontractor's work;[1] (2) 15%

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[1] At the time the parties entered into the contract, it was impossible to estimate administrative costs in the event of a default because the future costs were unknown. In fact, the very nature of large and complex

"administrative burden", i.e. the measure chosen by the parties, "is not a pre-set amount, but instead operates as a 'sliding scale,' accounting for the outstanding and remaining work to be completed at the time a party defaults"; (3) Winter presented evidence that 15% of the remaining subcontract value in case of default is the industry standard.

The mere fact that Winter's incurred direct expenses were $84,066 while the withdrawal allowed by the clause was of $350,000, does not transform the clause in a penalty. For that consequence, the "sum stipulated . . . [must be] so large that it is plainly disproportionate to any probable damage resulting from breach of the contract". *Tate,* 99 S.E.2d at 46. Here, it cannot possibly be so because "the sliding scale approach of the administrative burden provision ensures the sum stipulated is not disproportionate to any probable damage."

In conclusion, the Court held that Erie has failed to show that the provision is an unenforceable penalty and the facts establish that the provision was enforceable as a matter of law ("as a matter both of contract interpretation and of public policy, the administrative burden provision of the Subcontract is a valid, enforceable measure of liquidated damages."). Therefore, the Court of Appeals found that the trial court erred in granting summary judgment to Erie and in denying summary judgment to Winter.

From this case we can draw the following drafting advice for parties: make your liquidated damage clause in the form of a sliding scale and be sure to respect industry standard.

INTERNATIONAL

How implicit can the exclusion of CISG be? "Very" implicit according to some recent developments in case law.

If you missed it on the Internet, I want to call your

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construction projects is what makes damages difficult to ascertain in the first place.

attention to a very interesting short article: Clayton P. Gillette, Implicit Exclusion of CISG", available at http://blogs.law.nyu.edu/transnational/2011/04/implicit-exclusion-of-cisg.

The article deals with the debated issue of Article 6 of the Convention on the International Sale of Goods ("CISG"). The provision permits the parties to a contract otherwise subject to the CISG to exclude its application.

Among the states that have adopted CISG, disagreement exists, however on the requirements necessary for CISG not to apply. The article reminds lawyers of the following basic principles:

1) The insertion of a general choice of a law clause is not sufficient to exclude CISG. If you say, for example, that New York law applies, you are not opting out of CISG because CISG is part of the law of New York. Professor Gillette correctly points out that, by contrast, saying "The New York Uniform Commercial Code, and not the United Nations Convention on Contracts for the International Sale of Goods" is a sufficient opting out.
2) The manifested ignorance of the parties on the existence or the application of CISG probably does not work to exclude its applicability. The article refers, among others, to one decision of an Italian court, i.e. Tribunal of Padua, January 11, 2005, *Ostrotznik Savo v. La Faraona*[2] (holding that exclusion of CISG is possible only where the parties were aware of its applicability) and to one decision of a German court, i.e. Oberlandesgericht Linz, January 23 January, 2006. However, the article also refers to some recent American case law to the effect that an implicit exclusion of applicability of CISG is possible where the parties have

[2] See also Cristina Chiomenti, *Does the choice of a-national rules entail an implicit exclusion of the CISG? Comment on the decision of Tribunal of Padova (IT), 11 January 2005, Ostrotznik Savo v. La Faraona*, available at www.simons-law.com/library/pdf/e/652.pdf

failed to mention the CISG in their pleadings (which make express reference to internal law) and then attempted to rely on the CISG after discovery. In *Ho Myung Moolsan, Co. Ltd. v. Manitou Mineral Water, Inc.*, (S.D.N.Y. December 2, 2010), the court held that the parties by their actions had consented to the application of the New York Uniform Commercial Code (instead of CISG).

I do not agree with this decision because it rests on incorrect legal grounds, as Professor Gillette correctly points out. I have recently noticed a certain struggle of federal courts with the application of CISG. In issue no. 2 of this Contracts Tea, I have discussed some recent decisions that show a misunderstanding of CISG principles of offer and acceptance and of parties' intent in CISG. Now I have to register another misunderstanding, this time on Article 6 of CISG.

When Article 6 provides that "the parties may exclude the application of this Convention" it does not allow the court to refuse to apply the CISG only because a party does not plead it, as if CISG application was a defense and not part of the law of the country. I certainly agree with Professor Gillette when he writes: "[T]here seems something odd about the notion that parties, by their ignorance, can exclude the application of a body of law that the legislature has determined should govern a particular transaction" but I disagree on the fact that *Ho Myung Moolsan* could be justified on the principle "*iura novit curia*." This principle, besides being incorporated in the international case law on CISG,[3] is one of the basic doctrines of the Civil Law trial. By this Latin maxim, the Civil Law intends that the judge -- and not the parties -- determines the applicable law. The principle is also expressed by another maxim,

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[3] The article mentions another Italian decision, *Tribunal of Vigevano*, July 12, 2000 for the proposition that court can determine the law on its own. The decision in question, however, finds CISG applicable (holding that the mere reference to domestic law in the parties' pleadings is not in itself sufficient to exclude CISG).

"da mihi factum, dabo tibi ius," which means that the parties plead the facts while the law does not need to be pleaded (even if parties in their pleadings usually refer to the applicable law). It is for the judge to find the applicable law.[4] Civil Law courts, however, are not free to choose the rule or set of rules or body of law that they prefer to apply, they must apply *what is applicable*. And since CISG is part of the law, where it is applicable according to Article 1 of CISG, a court *must* apply it.

If the federal court had applied the maxim "*iura novit curia*" in *Ho Myung Moolsan,* the court should have applied CISG if the treaty was applicable pursuant to Article 1 and the application was not excluded in the contract. Even if it is true that you might have an implicit exclusion of CISG, the lack of reference in the pleading cannot amount to a waiver. This in fact would amount to a "too implicit" exclusion that is not justified by Article 6.

And, it is worth reminding, Article 6 governs this matter not domestic New York law. The court, on contrast, relied on a New York law that allowed parties in litigation to consent by their conduct to the law to be applied. This law, however, does not apply: CISG preempts state law because it is federal law by virtue of the ratification of the Convention.

[4] In fact, unlike in Common law, there is no duty on the part of the Civil Law lawyer to cite to relevant rules of law as there is for Common law lawyer to cite to binning precedents.