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Court Refuses to Enforce Liquidated Damages Clause

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Liquidated damages are a sum which a contracting party agrees to pay, or a deposit which they agree to forfeit, if he or she breaches some promise. A liquidated damages clause is enforceable only if it actually provides for liquidated damages and not for a penalty. A penalty is also a sum which a party agrees to pay or forfeit in the event of a breach. The difference lies in that, in the case of a penalty, the stipulated amount is fixed, not as a bona fide estimate of actual damages, but as a punishment, the threat of which is calculated to prevent a breach.

Recently, in GK Development v. Iowa Malls Financing Corp. 2013 IL App (1st) 112802, the Illinois appellate court struck down a liquidated damages clause as a penalty, which required that $4.3 million of the purchase price be held in escrow from the seller's proceeds to be paid to the seller only if certain conditions were timely met. There, the buyers purchased four shopping centers in eastern Iowa. A tenant in one of the shopping centers was in the process of expanding its grocery store.

One of the conditions was that the tenant obtain all permits and other governmental approvals necessary to complete the expansion prior to October 31, 2005. After it failed to do so, each party filed a separate lawsuit seeking a declaratory judgment regarding entitlement to the escrow funds. The trial court found that the parties intended a "drop-dead deadline" of October 31, 2005, for plan and permit approval and that the buyer was entitled to the escrow funds as liquidated damages for a breach of contract. The seller appealed to the appellate court.

Illinois courts will enforce a liquidated damages provision if:

(1) the parties intended to agree in advance to the settlement of damages that might arise from the breach;

(2) the amount of liquated dates was reasonable at the time of contracting, bearing some relation to the damages which might be sustained; and

(3) actual damages would be uncertain in amount and difficult to prove.

Here, the court found that the $4.3 million holdback did not meet the first two requirements and was not enforceable.

The first element had not been met because the parties did not agree that the $4.3 million would be damages for a delay in obtaining permits. Instead, the court found that the parties only considered the damages in light of a complete failure of the tenant's expansion to come to fruition and, accordingly, estimated the damages as the present-day value of the tenant's 20-year lease expansion, $4.3 million.

The second prong was not satisfied because the amount of liquidated damages bore no relation to the anticipated damages of a delay in performance. The $4.3 million amount was agreed upon because the parties calculated that the buyer would lose $430,000 each year if the tenant's expansion lease did not go through at all. While the $4.3 million liquidated damages might have been reasonable in the event that the expansion lease never occurred, it was not reasonable for what turned out to be a 91-day delay

securing government permits. Therefore, it was not a reasonable prediction of damages.

Finally, the appellate court found that the $4.3 million holdback constituted an unenforceable penalty clause because the provision amounted to a windfall recovery for buyer. "Windfall recovery" is a profit that occurs suddenly as a result of an event not controlled by the company or person realizing the gain from the event. The trial court had awarded the buyer the entire $4.3 million for a 91-day delay in approving construction permits even though the entire 20- to 45-year lease was still intact and the buyer would receive the benefits of that lease for the next 20 to 45 years. Under these circumstances, the liquidated damages awarded were grossly disproportionate to the buyer's loss. In essence, the trial court had allowed the buyer to receive a double recovery by not paying the $4.3 million purchase price to the seller for the tenant lease, while still recovering the $4.3 million for the lease over the next 20 plus years. The appellate court held this was a penalty and refused to enforce the liquidated damages clause.

Court Allows Expert to Testify Which Expert is Correct

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In Unitrin Preferred Insurance Co. v. Dobra, 2013 IL App (1st) 121364, In a recent Illinois appellate court opinion, the court approved the use by one party of an expert to testify which expert was correct as to the cause and origin of a fire. The lawsuit arose from a fire that occurred at the home of the plaintiff's insured, after the defendant-contractor installed and finished hardwood floors using a flammable liquid. The plaintiff-insurer paid to repair the damage resulting from the fire and subsequently filed suit against the contractor for subrogation.

Each party retained a certified fire cause and origin expert, and each came to a completely different opinion regarding the origin and cause of the fire. The plaintiff's expert concluded that the fire originated in the basement of the insured's home, after some flooring finish dripped down a floor duct and became ignited by a furnace pilot. In contrast, the defendant's expert concluded the fire was caused by an undetermined electrical fault in a television located in the insured's kitchen.

Prior to trial, the defendant also retained a fire scientist and protection engineer to provide an expert opinion regarding which fire cause and origin expert was correct in his conclusion. In addition to his experience and training as a fire protection engineer, the expert had been involved in the development of NFPA 921 Guide for Fire and Explosion Investigations, an important and widely used reference source in fire cause and origin determinations.

The plaintiff-insurer sought to bar the fire scientist's opinions regarding which expert's opinion was correct as to the cause and origin of the fire. Specifically, the plaintiff argued that a fire protection engineer is different from a fire cause and origin expert, and such testimony was cumulative of the testimony already offered by the defendant's fire cause and origin expert. However, relying upon the defendant's offer of proof, the trial court disagreed and allowed the fire protection engineer to testify. At trial, the jury returned a verdict in favor of the defendant-contractor, stating that the testimony of the fire scientist was most significant because he "looked at both sides' theory."

On appeal, the plaintiff argued that the fire scientist 1) did not possess the requisite expertise in the field of fire cause and origin investigation, and 2) usurped the role of the jury at trial. In response, the defendant argued that the expert was qualified to testify because, although 'fire science' does not address the procedural aspects of cause and origin investigation, it is related to fire investigation by providing an understanding of how fires develop, how materials contribute to the fire, and how buildings react to fire, thereby underlying the determination of fire cause and origin investigation.

The appellate court affirmed the trial court's ruling. First, the court held that the fire scientist's testimony assisted the trier of fact with the issue of fire causes and origins, an issue not within the general knowledge of a layperson. Second, in addition to completing the education necessary to hold himself out as a fire scientist and fire protection engineer, the court recognized that the expert was qualified to testify

regarding the cause and origin of the fire because he was associated with the development of NFPA 921, the specific method used by fire investigators to hypothesize fire causes and origins.

Regarding the plaintiff's second argument, the court noted that the purpose of the expert's testimony was to aid the trier of fact in determining where and how the fire started, which the jury was free to disregard. Further, nothing in the record suggested that the plaintiff was precluded from introducing an expert of its own to counter the fire scientist. Therefore, no prejudice resulted to the plaintiff, and the trial court was within its sound discretion in allowing the expert to testify.

Court Looks Beyond Contract to Decide Contractor's Duty of Care

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In a recent Illinois appellate court case, Gomez v. Bovis Lend Lease, Inc., 2013 IL App (1st) 130568, a construction manager and contractor, who each were sued by an injured worker, appealed the summary judgment order dismissing the contribution actions they brought against a third-party defendant. On appeal, the construction manager and contractor argued that summary judgment was improper because:

(1) the contract unambiguously imposed a duty upon the third-party defendant to provide support for the infill areas for the Trump Tower project,

(2) the use of extrinsic evidence to interpret the contract would create a genuine issue of material fact, and

(3) the parties' expert opinions regarding proximate cause also created a genuine issue of material fact.

The court affirmed the lower court's order, finding that while the contract was ambiguous, extrinsic evidence showed that the third-party defendant did not have a duty to provide support for the infill areas.

The court first considered the contract between the parties. The construction manager and contractor referenced clauses that they contended imposed a duty on the third-party defendant to provide support for the infill areas. Notably, none of the provisions referenced the infill areas. They cited one clause in particular that stated that the third-party defendant was to "design, engineer, detail, fabricate, deliver and lease . . . all the forming systems required to form the concrete for the project known as Trump International Hotel and Tower" and argued that an infill area was a forming system. The court rejected this argument since the contract did not state that forming systems included infill areas.

The third-party defendant, on the other hand, cited to the only clause expressly mentioning infills. The provision excluded any duty for the third-party defendant to supply "plywood for Multiflex forming systems or Skydeck infills." The third-party defendant then cited a clause stating that it must "provide all necessary shop drawings and design and technical design services for the application of all material supplied hereunder." Thus, the third-party defendant argued that since it was not to supply the plywood for infills, it had no duty to provide technical support for them. The court then decided the contract was ambiguous since it could be interpreted in more than one way and, thus, the court could not ascertain the parties' intent from its four corners.

The court then considered extrinsic evidence, information not contained within the actual contract, to determine whether the third-party defendant had a duty regarding the infill areas. Specifically, the court considered the fact that prior to the Trump Tower project, the contractor and the third-party defendant had worked together on over 20 other projects. During those other projects, the contractor had never requested and the third-party defendant had never provided support services for the infill areas. The construction manager and contractor tried to distinguish the prior projects from the Trump Tower project due to its size. The court explained, however, that if the third-party defendant's duties were to differ from the other projects, the contractor should have been explicit as to the duty to provide support

for the infill areas. Additionally, the contractor neither requested that the third-party defendant provide designs, drawings, or support for the infill areas during the project, nor did it indicate that the third-party defendant's performance was deficient. It was not until the contribution claim was filed that the contractor even suggested that the third-party contractor had a duty to provide support for the infill areas

The court therefore concluded that summary judgment was proper because the extrinsic evidence failed to establish that the third-party defendant had a duty to provide support for the infill areas of the Trump Tower project.

Indiana Courts Uphold Validity of Mechanics Lien Notices

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Recently, the Indiana court of appeals had the opportunity to address the technical requirements of notice under the applicable Indiana statutes governing liens on construction projects. In Von Tobel Corporation v. Chi-Tec Construction & Remodeling, Inc., 2013 WL 5011985 (Ind. Ct. App., Sept. 13, 2013), the supplier on a construction project filed a pre-lien notice and a subsequent lien on the residential property due to non-payment from the general contractor. The owner of the property argued that the pre-lien notice and subsequent lien were insufficient because the name of the corporation on the pre-lien notice, Von Tobel Home Center, Inc., was not the same corporation that filed a lien on the property, Von Tobel Corporation. After reviewing the applicable statute, the appellate court determined that the underlying purposes of the Indiana Mechanics Lien Act was remedial and that, although a technical violation of the Act occurred it was minimum, there was sufficient notice to inform the owner of the property that a claim for materials furnished on the construction site of the residence was being asserted by Von Tobel Corporation, and there was no prejudice to the owner.

In The City of Ft. Wayne v. Consolidated Electrical Distributors, Inc., 998 N.E.2d 733 (Ind. App. 2013), the court looked at the notice required for a lien on public projects. In compliance with the notice requirements of the statute, the subcontractor on the public project at issue provided its notice of a non-payment within 60 days after last performing services on the project to the mayor, rather than the parks department board which let the contract. The Act requires that notice be filed with the "board" not later than 60 days after the last performance of services. "Board" is defined as "the board or officer of a political subdivision or an agency having the power to award contracts for public work." The city argued that the subcontractor could not serve the mayor since the mayor did not award the contract. Relying on the last-antecedent rule in interpreting the statute, the court concluded that the mayor was an officer of the municipality and was properly served. The court concluded that the rules of statutory construction supported the subcontractor's position that the mayor did not have to have the power to award the contract to be the proper person served under the Act.

Although both of the above-mentioned cases resulted in lien rights being affirmed, these cases should not be relied upon as examples of acceptable non-compliance with the exact requirements of the Indiana mechanics lien statutes. Although the court in each case reached its conclusions using well-settled statutory interpretation principles, it is presumed that great expense was incurred in the trial and appellate courts by each subcontractor to reach the results. Therefore, it is always advisable that clients understand and follow the particularities and nuances of each statute to ensure that the exact requirements are followed closely to avoid costly litigation.

Court Stretches to Find Fabricator Owed Coverage as an Additional Insured

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In a recent case, the Illinois appellate court confirmed the power of the courts to go beyond the allegations of the complaint to determine whether an insurer

owed a duty to defend an additional insured in a construction accident case. There, the court held that it could look at the allegations of third-party complaints filed against the additional insured to see if the insurer had to defend an additional insured. See Illinois Emcasco Insurance Co. v. Waukegan Steel Sales, Inc., 2013 IL App (1st) 120735.

In Emcasco, a steel fabricator hired a steel erector to erect steel at a job site. The subcontract stated that the steel erector was "solely responsible for the means, methods and safety of its employees." Under the subcontract, the erector also had to cover the fabricator as an additional insured under the erector's insurance policy.

An employee of the erector was injured at the job site when he fell. The worker sued the fabricator alleging that the fabricator did not provide a safe place to work or proper fall protection.

The fabricator tendered its defense in the lawsuit to the erector's insurer, pursuant to the additional insured provision of the policy. The insurer denied coverage because the additional insured provision of the policy stated that the fabricator would only be covered for its vicarious liability arising as a direct result of the erector's conduct. The insurer pointed out that the injured worker alleged that the fabricator's negligence caused his injuries. Accordingly, any liability of the fabricator arose from the fabricator's negligence and not any negligence of the erector. Under such circumstances, the insurer reasoned that the fabricator would not be vicariously liable for the negligence of the erector. Accordingly, the insurer concluded that the policy did not cover the claims made against the fabricator in the lawsuit filed by the worker because the additional insured provision only covered the fabricator for its vicarious liability due to the acts of the erector and not for "any act or omission" of the fabricator.

The court noted, however, that two third-party complaints had been filed against the fabricator by defendant-contractors in the case. In both of the third-party complaints, those contractors claimed that the direct negligence of the erector caused the employee's injuries. The court reviewed the third-party complaints to determine if the insurer owed a duty to defend the fabricator, relying on a recent Illinois case which held that the court could look beyond the four corners of the complaint to determine if an additional insured may be covered by an insurance policy for the claims alleged in the complaint.

The court found that the third-party complaints alleged in part that the erector was acting as the agent, servant or employee of the fabricator. Hence, the court reasoned that the claims made against the fabricator may be covered under the erector's insurance policy. The court reasoned that there was a possibility that the fabricator could be found vicariously liable for the negligence of the erector, if the trial court found that the fabricator was the employer or principal of the erector. Accordingly, the court held that the erector's insurer had to defend the fabricator in the injured worker's lawsuit.

QUERREY & HARROW ELECTS NICHOLAS JOHNSON AS SHAREHOLDER

Querrey & Harrow is pleased to announce that Nicholas Johnson has been elected to Shareholder. Mr. Johnson practices out of both Querrey & Harrow's Chicago and Waukegan offices. Mr. Johnson focuses his practice on civil litigation, construction law, business litigation, and contract law.

Mr. Johnson received his BA degree from the University of Wisconsin in 2000, and his JD degree, magna cum laude, from Thomas M. Cooley Law School in 2005. He is admitted to practice in both Illinois and Wisconsin, and is a member of the federal trial bar.

Construction Law for Public Projects
HalfMoon Education, Inc.
March 28, 2014

On March 28, 2014, in Wheaton, Illinois, Querrey & Harrow attorneys Bruce Schoumacher, Anthony Madormo, Larry Kowalczyk, Tim Rabel, and Jason Callicoat will participate in an all-day seminar concerning construction law for public projects. Specific topics to be covered include:

- Public Procurement Law
- Current Issues
- Design Contracts and Project Management
- Construction Contract Provisions
- Prevailing Wage Laws
- Subcontractor Issues
- Construction Bonds Construction Claims
- Dispute Resolution Ethical Issues

For additional information and registration, please visit the HalfMoon Education website.

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