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Bulletin

# ENFORCEABILITY OF CONTRACTUAL FINES/PENALTIES FOR SUBCONTRACTOR SAFETY VIOLATIONS

## INTRODUCTION

While liquidated damages clauses and indemnity provisions are commonplace in subcontract agreements, it is not unusual to find contractual provisions that seek to impose additional fines or penalties against subcontractors for safety violations. Most states have not yet determined the legality of these provisions, but, as discussed in detail below, such provisions are likely unenforceable. An example of a "safety fine/penalty" provision is below.

## WHY IT'S IMPORTANT

Subcontractors should be aware of these provisions as they can lead to disputes. A prime contractor could use these provisions to abuse the back charge process and take advantage of subcontractors. Under the language included in the example provided, if a subcontractor accident caused a recordable injury but the subcontractor refused to put its check "in the bowl," the general contractor would likely back charge the subcontractor for the contribution.

If the prime contractor withholds payment of a subcontractor's pay application as leverage to resolve the back charge, the subcontractor's cash flow would be impacted and could lead to a larger dispute over the entire amount of the pay application. If the contractor pays the subcontractor the funds requested, less the back charge, the financial impact will be reduced but the subcontractor must still decide whether to fight over the improper back charge. This becomes even murkier when the cause of the accident leading to the injury is disputed or unclear. So what should a subcontractor do when faced with such a provision?

Exhibit "H"

SUBCONTRACT SAFETY EXHIBIT

9. Subcontractor accident will be fined accordingly: recordable injuries 2% of subcontract value, up to a Maximum of $5,000. Fine will increase by 2% (or $5,000 Max) for each subsequent accident within a 12 month period. Subcontractor must contribute this fine in person at our monthly safety meeting, where the Subcontractor will place his check in the in bowl with general contractor project team checks and participate in explaining the accident with our team. In addition, Subcontractor's Project Executive or Owner will attend 5 consecutive morning JSA's with their crews following a recordable injury, 10 JSA's for the second, and 15 JSA's for the third recordable incident in a 12 month period.

**WHAT TO DO**

The subcontractor should first attempt to **delete the provision** entirely. When discussing the reason for the deletion with the general contractor, the subcontractor should explain:

1) The indemnity provision in the subcontract requires the subcontractor to reimburse the general contractor for any actual damages to the general contractor resulting from injuries; and

2) The safety fine/penalty provision is an unenforceable liquidated damages clause.

Discussion on these two rationales is provided below, but what should the subcontractor do if the general contractor is unwilling to remove the entire provision from the subcontract?

If the provision is not deleted, the subcontractor should next attempt to **negotiate more favorable terms** regarding the amount of the fine/penalty and attempt to clarify the penalty provision as much as possible. Negotiate the lowest possible fine amounts per violation and negotiate a cap on the total possible fine amount.

In clarifying the penalty provision, the subcontractor should attempt to clarify that the fine applies only if the subcontractor is found to be at fault by OSHA or some other third party. For example, it is unclear in the provision above whether the party causing the accident will pay the fine or the subcontractor employing the injured worker will pay the fine. This could be clarified by stating, “Subcontractors causing recordable injuries, as determined by OSHA, will be fined as follows...”

Finally, what should a subcontractor do if the general contractor attempts to enforce the provision? If the general contractor attempts to enforce the provision, the subcontractor can **attempt to resolve** any disputed fines based on the reasoning included below. If an acceptable solution cannot be negotiated, the subcontractor will have to hire a lawyer to **challenge the fine(s)** based on case law and statutes.

**THE LAW**

Few (if any) court decisions examine contractual fines imposed upon subcontractors for safety violations. Therefore, we must look to similar areas of the law.

In this case, the typical subcontract would contain the most analogous contractual language in the liquidated damages clause. Most states unambiguously hold that liquidated damages clauses are void unless the contracting parties calculate the damages to reimburse the injured party for damages actually incurred. Accordingly, if the general contractor does not suffer actual damages as a result of an injury, the safety provision requiring payment from the subcontractor to the general contractor is likely an unenforceable penalty.

Simply stated, under a liquidated damages analysis, such a safety fine/penalty provision would be an unenforceable penalty without any actual damages sustained by the general contractor. Meaning, if the general contractor was not assessed a financial penalty by a city, state agency, municipality, or OSHA, and the general contractor did not reimburse the injured party for lost wages or medical expenses, the general contractor cannot levy arbitrary fines against a

subcontractor since the general contractor has not sustained any actual damages.

This rationale does not preclude the general contractor from seeking contractual indemnity for safety violations resulting in actual damages to the general contractor, but the imposition of a fine/penalty is against public policy in a vast majority of jurisdictions.

## LIQUIDATED DAMAGES

Generally, the United States aligns with other common law countries (such as England, Canada, and Australia) when interpreting the validity of liquidated damages clauses. In common law countries, liquidated damages must be proportionate to the anticipated harm and they may not be used as a penalty for non-performance.

Civil law countries (such as China, Russia, and many European countries) allow more contractual freedom to penalize actors for non-performance. In these countries, liquidated damages may penalize a breach or non-performance. Louisiana is the only U.S. state which follows this more expansive interpretation of liquidated damages.

A survey of various states indicates that very few—and possibly no—courts have specifically ruled on the legality of monetary fees/penalties imposed upon subcontractors for safety violations. However, all of the states—except Louisiana—share a similar basic disposition on the subject of liquidated damages. The courts in the surveyed states generally held that liquidated damages provisions may be utilized when the parties cannot easily ascertain the damages upon breach of the subject contract at the time of contracting. In order for the courts to enforce a liquidated damages provision, the liquidated damages must also be proportionate to the actual/anticipated damages and not merely a penalty to induce performance. Liquidated damages are unenforceable if a court determines the provision is merely a penalty. As written, American laws fall into three basic categories on the issue of liquidated damages:

1) Uniform Commercial Code ("U.C.C.") states – (43 states);
2) U.C.C. states with additional laws – (MT, ND, OK, & SD); and
3) Non-U.C.C. states – (CA, GA, & LA).

## UNIFORM COMMERCIAL CODE STATES

A majority of states have codified the U.C.C. liquidated damages language into their respective statutes. The applicable U.C.C. section states:

"Damages for breach by either party *may be liquidated* in the agreement *but only at an amount which is reasonable in the 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*. U.C.C. § 2-718 (emphasis added).

States that have implemented the U.C.C. language will invalidate a liquidated damages clause when it is determined to be a penalty. The U.C.C. also lays out the two-part test to determine if the clause is a penalty provision and therefore void.

**1) Harm Difficult to Estimate**:

The basic purpose of a liquidated damages clause is to apportion possible

future damages when those damages are unknown. Therefore, to be an enforceable liquidated damages clause, the economic harm must be difficult to ascertain at the time of contract.

**2) Award Proportional to Actual/Anticipated Damages**:

Part two of the enforceability test requires the amount of awarded liquidated damages to be reasonable and proportional to the anticipated or actual damages. If disproportionate to the actual damages, a court should find that the liquidated damages award was intended to penalize the breaching party and is therefore unenforceable.

Although the language utilized by the individual courts can vary, U.C.C. states incorporate this basic two-step "no penalty" test.[1] When challenged, a contractual penalty is most often invalidated because it fails the second prong of the test—the penalty awarded is disproportionate to the actual/estimated damages. In our scenario, if the general contractor were to incur money damages from a subcontractor's safety violation, then a contract may be able to apportion those damages to the offending subcontractor only in a reasonable proportion to the general contractor's actual damages.

## U.C.C. STATES WITH ADDED PROTECTIONS

Montana, Oklahoma, North Dakota, and South Dakota have incorporated the above-cited U.C.C. language, but these states have enacted additional laws. Essentially, these states have explicitly shifted the burden onto the party seeking to enforce the liquidated damages clause to prove why the liquidated damages clause should be enforceable. In the context of the subcontract fine/penalty provisions, these states would presume any such provision is invalid. Similar to the U.C.C. states, if the general contractor is not fined or damaged but imposes a penalty on the subcontractor, the penalty would be void. In addition, even if the general contractor is fined, the corresponding fine imposed upon the subcontractor must be proportional or the penalty would still be void.

## NON-U.C.C. STATES

Finally, three states do not utilize the U.C.C. language or analysis. All three offer a more deferential approach to liquidated damages when compared to the U.C.C. states. However, in two of those states—Georgia and California—the likely outcome remains the same. In California or Georgia, the underlying laws presume that liquidated damage provisions are enforceable,[2] but the

[1] For example:
**Texas** – "[T]he actual damages caused by the breach of contract **must be impossible or difficult to estimate**; and (2) the amount of liquidated damages called for under the contract **must be a reasonable forecast of just compensation**." *Phillips v. Phillips*, 820 S.W.2d 785, 788 (Tex. 1991) (emphasis added).
**Florida** – "**First**, the damages consequent upon a breach **must not be readily ascertainable**. **Second**, the sum stipulated to be forfeited **must not be so grossly disproportionate to any damages** that might reasonably be expected to follow from a breach as to show that the parties could have intended only to induce full performance, rather than to liquidate their damages." *Lefemine v. Baron*, 573 So. 2d 326, 328 (Fla. 1991) (emphasis added).
**New York** – A provision "will be sustained if **the amount liquidated bears a reasonable proportion to the probable loss and the amount of actual loss is incapable or difficult of precise estimation**." *Truck Rent-A-Ctr., Inc. v Puritan Farms 2nd, Inc.*, 41 NY2d 420, 425 [1977] (internal citations omitted and emphasis added).
**Illinois** – "To ascertain whether a liquidated damages provision is merely a penalty and therefore void, it must be determined whether (1) the **amount established is reasonable** in light of the anticipated or actual loss caused by the breach and (2) a level of **difficulty exists** in proving that a loss has occurred, or **in establishing the amount of the loss** with reasonable certainty." *Pav-Saver Corp. v. Vasso Corp.*, 143 Ill. App. 3d 1013, 1018, 493 N.E.2d 423, 427 (1986) (emphasis added).

[2] For service related contracts, California offers more statutory freedom to contract for liquidated damages by establishing a presumption of validity. "[A] provision in a contract liquidating the damages for the breach of the contract **is valid unless the party seeking to invalidate the provision establishes that the provision was unreasonable**

liquidated damages must still show a reasonable relationship to the probable loss.[3]

Louisiana stands alone as the true outlier. In Louisiana, a penalty clause is likely to be upheld even if the contractual damages are explicitly designed to penalize non-performance or breach.[4] However, even in Louisiana, the penalty—although enforceable—may still be reduced by the court if it is deemed manifestly excessive and against public policy.

## A MORE REASONABLE SOLUTION: INDEMNITY

Unlike a fine/penalty clause which would be void in nearly all American jurisdictions, indemnity clauses are almost universally acceptable.
In this context, they remain enforceable because they merely seek to apportion damages rather than penalize a non-performing party.[5] In addition, no state allows the non-breaching party to recover both actual damages and the contractual liquidated damages award. All states prohibit double recoveries.[6]

Therefore, if a contract contains a suitable indemnity provision, any other fine/penalty imposed would constitute recovery beyond the actual damages and be void, regardless of the jurisdiction. For a subcontractor fine/ penalty provision, if an indemnity clause is also in the contract, the fine/ penalty provision is even more likely to be void.

## CONCLUSION

In a vast majority of states, a contractual provision which permits a general contractor to levy monetary fines and penalties on a subcontractor for alleged safety violations, (absent any real damages sustained by the general contractor), would likely be ruled an unenforceable penalty provision.

Indemnity is the best—and possibly only valid—method to ensure that a contractor apportions damages for safety violations to a subcontractor. Any other contractual penalty is likely void in every state except Louisiana. Parties would be advised to contract accordingly.

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under the circumstances existing at the time the contract was made."
Cal. Civ. Code § 1671(b) (emphasis added).
If the parties agree in their contract what the damages for a breach shall be, they are said to be liquidated and, **unless the agreement violates some principle of law, the parties are bound thereby**.
Ga. Code § 13-6-7 (emphasis added).

[3] "[C]ourts invalidate liquidated damages clauses as a penalty only if the damages imposed have **no reasonable relationship to predicted actual damages**." *Ridgley v. Topa Thrift & Loan Ass'n*, 17 Cal. 4th 970, 977, (1998).
In Georgia, a contractual provision "will be treated as an **enforceable liquidated damages provision rather than an unenforceable penalty only if all three of the following factors are present**: First, the injury caused by the breach must be difficult or **impossible of accurate estimation**; second, the parties must intend to **provide for damages rather than a penalty**; and third, the stipulated sum must be a **reasonable pre-estimate of the probable loss** resulting from such a breach." *Broad. Corp. of Georgia v. Subscription Television of Greater Atlanta*, 177 Ga. App. 199, 338 S.E.2d 775, 776-77 (1985) (emphasis added).

[4] Parties may stipulate the damages to be recovered in case of nonperformance, defective performance, or delay in performance of an obligation. La. Civ. Code art. 2005.
An obligee who avails himself of a stipulated damages clause need not prove the actual damage caused by the obligor's nonperformance, defective performance, or delay in performance. La. Civ. Code art. 2009.
Stipulated damages may not be modified by the court unless they are so manifestly unreasonable as to be contrary to public policy. La. Civ. Code art. 2012.

[5] Below is an enforceable indemnity provision promulgated by the American Institute of Architects which is often included in construction subcontracts:

§4.6 Indemnification

§ 4.6.1 To the fullest extent permitted by law, the Subcontractor shall indemnify and hold harmless the Owner, Contractor, Architect, Architect's consultants, and agents and employees of any of them from and against claims, damages, losses and expenses, including but not limited to attorney's fees, arising out of or resulting from performance of the Subcontractor's Work under this Subcontract, provided that any such claim, damage, loss or expense is attributable to bodily injury, sickness, disease or death, or to injury to or destruction of tangible property (other than the Work itself), but only to the extent caused by the negligent acts or omissions of the Subcontractor, the Subcontractor's Sub-subcontractors, anyone directly or indirectly employed by them or anyone for whose acts they may be liable, regardless of whether or not such claim, damage, loss or expense is caused in party by a party indemnified hereunder. Such obligation shall not be construed to negate, abridge, or otherwise reduce other rights or obligations of indemnity which would otherwise exist as to a party or person described in this Section 4.6.

4.6.1 AIA Document A401-2007

[6] An obligee may demand e**ither the stipulated damages or performance of the principal obligation, but he may not demand both** unless the damages have been stipulated for mere delay.
La. Civ. Code Ann. art. 2007 (emphasis added).

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