The Evolution of Valid Liquidated Damages Provisions and Void Penalties in American Contract Law

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I. Introduction

When forming a contract, parties in the United States can agree to determine reasonable estimates of unknowable damages that must be paid by one party to the other for a future breach. When properly formed, these provisions for predetermined damages will be enforced as liquidated damages. Reasonable damage estimates cannot, however, stray very far from this purpose. From its early development in England, the common law has long disfavored the notion of penalty provisions in contracts, much to the chagrin of some civil law practitioners. The American courts' disfavoring of predetermined penalties may at first seem somewhat in conflict with the general principle that parties should have the freedom to contract for nearly anything, barring exceptions such as mistake, fraud or illegality. Perfectly valid agreements could generally include terms and conditions that may or may not be well-advised, without inviting judicial supervision or scrutiny. The parties themselves should be able to determine what is reasonable regarding price, quality, delivery terms, and the like. However, courts are less restrained in regard to reviewing predetermined remedies that parties may agree to in a contract, to determine whether a payment for breach will be treated as enforceable liquidated damages, or an invalid penalty.[1)]

Penalty provisions may have the ostensibly pure purpose of establishing a clear and predetermined punishment for a party's failure to meet the contractual obligations to which each side willingly agreed. Fear of suffering from such punishment would ideally provide additional disincentive for a party to consider a breach of their obligations. Punishment, however, is not a goal of common law contract formation. Rather than serving to punish a breach, predetermining damages is meant to compensate the promisee as a redress. Strict judicial review of predetermined payment clauses provides benefits that include forcing the parties to more carefully consider potential estimated losses in the event of a breach, reduce the costs of proving a future breach, and reduce the time and money that would otherwise

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1) *See* Joseph M. Perillo, *Contracts* 558 (7th ed., West Academic Publishing 2014) and Dan B. Dobbs and Caprice L. Roberts, *Law of Remedies* 850-51 (3d ed., West Academic Publishing 2018).

be spent on a trial.[2] As liquidated damages are not penalties, they are valid and enforceable. The distinction may at times appear somewhat arbitrary, but the principle has a long history on both sides of the Atlantic, and in most cases, strikes a balance between upholding the predetermined damages agreed to by the parties, and the need to protect parties from unjust consequences from circumstances impossible to predict.

As a common law jurisdiction, courts in the United States of America have historically refused to enforce unreasonable liquidated damages provisions, and instead branded them unenforceable penalty clauses. This article will provide an overview of the common law treatment of liquidated damages from their origins in England, their evolution in the United States of America, the subsequent refinements in the Restatement of Contracts, and as codified under the Uniform Commercial Code ("UCC").

II. Historical Development in England from Penal Bonds to Liquidated Damages

Even in the best of circumstances, determining damages in the event of a contract breach can be a time-consuming and expensive process. To circumvent such difficulties, contracting parties from long ago tried to find ways of predetermining remedies that would be available in the event of contract breaches.[3] One such method borrowed from the concept of penal bonds, which originated in medieval England and were used until the late 1700s as a tool for ensuring contract compliance.[4]

The penal bond evolved from an obligation to pay a penalty for failure to perform a condition into a promise to perform an act, with the payment serving as a form of damages to compensate for nonperformance. In other words, under early penal bonds, an obligor was immediately considered to be liable for payment, with later performance as a method of discharging the debt. A plaintiff would only need to prove the penal bond was executed in order to collect, placing an affirmative burden of proof on the defendant to show that the bond's discharging act was actually performed. Early penal bonds often served as additional motivation for completion of the promised performance, with much importance placed on the form of the agreement. Over time, the importance of the form of the bond decreased, while the focus on the purposes of these agreements increased. Penalties were often excessive in relation to the promised performance.[5]

The English Court of Chancery began taking a negative view of the penalties imposed by such bonds beginning in the 1500s.[6] As the courts gradually regarded it as unfair for an

2) E. Allan Farnsworth, *Contracts* 935 (2d ed., Little, Brown and Company 1990).
3) Arthur Linton Corbin, *Corbin on Contracts Vol. 5* § 1054 319 (West Publishing Co. 1964).
4) Curtis Nyquist, *A Contract Tale from the Crypt*, 30 Hous. L. Rev. 1205, 1232-33 (1993).
5) Corbin, *supra* note 3, at 322-25.
6) Nyquist, *supra* note 4, at 1233.

obligee to enforce a penalty in lieu of an expected judicial remedy for a breach, English law disfavoring contract penalties became a policy originating in equity.[7] In principle, English law did not permit penalty clauses in contracts because the courts held that parties should not be punished for breaching alone. Thus, even mutually agreed penalty terms duly considered in good faith would not be enforced if they were not true damage estimates.[8] The determination of whether a predetermined payment was a valid liquidated damages clause or an unenforceable penalty would be a question of the clause's construction and the circumstances as existed at the time the contract was formed, rather than at the time of the breach. However, an agreed amount that was less than the probable amount of actual damages could be enforced as a cap on damages.

The landmark case *Dunlop Pneumatic Tyre Co., Ltd. v. New Garage and Motor Co., Ltd.*[9] consolidated precedent into a modernized test for courts to use in determining whether a predetermined payment was a penalty or liquidated damages. Dunlop was a manufacturer of tires and related products. It agreed to sell New Garage, a retail dealer, such goods at wholesale prices on the condition that the retailer would not sell the products at prices lower than Dunlop's list prices. When New Garage sold an item below the list price, Dunlop claimed a breach of their contract, and demanded a payment of five pounds for each item sold in breach of the terms, as liquidated damages. New Garage countered that these provisions constituted an unenforceable penalty clause.

Lord Dunedin set forth comprehensive rules to differentiate between liquidated damages and penalties under English law as summarized below:

> 1. Though the parties to a contract who use the words "penalty" or "liquidated damages" may prima facie be supposed to mean what they say, yet the expression used is not conclusive. The Court must find out whether the payment stipulated is in truth a penalty or liquidated damages...
> 2. The essence of a penalty is a payment of money stipulated as in terrorem of the offending party; the essence of liquidated damages is a genuine covenanted pre-estimate of damage.
> 3. The question whether a sum stipulated is penalty or liquidated damages is a question of construction to be decided upon the terms and inherent circumstances of each particular contract, judged of as at the time of the making of the contract, not as at the time of the breach.
> 4. To assist this task of construction various tests have been suggested, which if applicable to the case under consideration may prove helpful, or even conclusive.

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7) Neil Andrews, *Contract Law* 601 (Cambridge University Press 2011).

8) *See* John Cartwright, *Contract Law* 201, 270 (Hart Publishing 2007) and J.W. Carter, *Breach of Contract* 457 (The Law Book Company Limited 1984).

9) Dunlop Pneumatic Tyre Co., Ltd. v. New Garage & Motor Co., Ltd. [1915] A.C. 79.

> Such are: (a) It will be held to be penalty if the sum stipulated for is extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have followed from the breach. (b) It will be held to be a penalty if the breach consists only in not paying a sum of money, and the sum stipulated is a sum greater than the sum which ought to have been paid… (c) There is a presumption… that it is penalty when "a single lump sum is made payable by way of compensation, on the occurrence of one or more or all of several events, some of which may occasion serious and others but trifling damage". On the other hand: (d) It is no obstacle to the sum stipulated being a genuine pre-estimate of damage, that the consequences of the breach are such as to make precise pre-estimation almost an impossibility. On the contrary, that is just the situation when it is probable that pre-estimated damage was the true bargain between the parties.[10)]

In finding that the stipulated terms to be a non-unconscionable, genuine pre-estimate of potential damages, the court upheld the payments as valid liquidated damages. The contract itself provided that the five pounds per violation were to be paid "by way of liquidated damages and not as a penalty".[11)] As per the first requirement, this language alone was not dispositive, and so the court looked at the circumstances surrounding the agreement. Similarly, a genuine attempt to estimate uncertain damages may be upheld as liquidated damages, even if the contract itself erroneously refers to the sum as a "penalty".[12)]

As to the second factor, the amount of damages assessed bore a reasonable relationship to the potential loss of profit for each tire sold at a price in breach of the contract. While the actual market value of the tires could be easily determined, "damage from any one sale would be impossible to forecast."[13)] Further, the sum was not "extravagant" in relation to the anticipated harm at the time the contract was formed, which is an element of the fourth factor. The damages clause was therefore enforceable, and New Garage was liable for paying liquidated damages for its breach.

Ultimately, whether a predetermined payment under a contract is liquidated damages or a penalty is a question of law.[14)] The English common law development and the principles detailed under *Dunlop* would not only set definitive precedent domestically, but it would also serve to influence the development of the treatment of penalty clauses in American contract law.[15)]

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10) *Id.* at 86-88 (internal citations omitted).

11) *Id.* at 81.

12) J. Beatson, QC, *Anson's Law of Contract* 587 (Oxford University Press 1998). *See* Cellulose Acetate Silk Co. Ltd. v. Widnes Foundry (1925) Ltd., [1933] A.C. 20.

13) Dunlop, *supra* note 9, at 88.

14) H.G. Beale, Q.C. (Hon.), ed. *Chitty on Contracts Vol. I* 1866 (31st ed., Sweet & Maxwell Limited 2012).

15) Though this review of English common law developments in liquidated damages and penalty ↗

III. American Adoption and Adaptation of the Common Law

The adoption of English common law by the American colonies was immediate, but perhaps not quite up to the standard of the motherland at the beginning. Sophisticated courts and legal professionals did not arrive with the first colonists. Although colonial America began with "a period of rude, untechnical popular law", it was transformed with the increase in educational institutions and legal professionals and the gradual adoption of most English common law rules into the domestic system.[16] As the legal system at large matured, so did the body of contract law that grew along with the expanding United States economy and ever-increasing complexities in business deals.

A. The American Common Law and the First Restatement of Contracts

As discussed above, penal bonds were used in early common law history as a security to compel contract performance. Common law courts would order the bond paid to the promisee in the event of any breach by the promisor, regardless of the actual amount of the loss. Over time, principles of equity had taken hold that required payments to be based on actual losses as determined at trial. This principle as first applied to penal bonds eventually took hold over all contractual penalty claims.[17] The concept of liquidated damages became an acceptable way for parties to predetermine damages upon signing a contract that would be payable in the event of a future breach. As they were not penalties, they would be enforceable.

In 1923, a group of judges, lawyers, and law professors formed the American Law Institute, with the goal of consolidating the mass of case law into a manageable set of rules. The volume known as the Restatement of Contracts[18] was published nine years later. It was neither a replacement of the case law nor a statutory fix to what could be differing outcomes from different jurisdictions. Instead, it was meant to serve as a resource offering legal professionals a bedrock of persuasive legal authority.[19]

↘provisions ends here for the purposes of tracking the American common law treatment of liquidated damages from its origins, English law on liquidated damages did not, of course, end with *Dunlop*. In particular, a significant change to the historically strict assessment of potential penalties came in Cavendish Square Holding BV v. El Makdessi; ParkingEye Ltd. v. Beavis [2015] UKSC 67. Predetermined damages no longer need to be true pre-estimates of damages and may serve as deterrents to an extent. "The true test is whether the impugned provision is a secondary obligation which imposes a detriment on the contract-breaker out of all proportion to any legitimate interest of the innocent party in the enforcement of the primary obligation." *Id.* at para. 32. The stricter prohibitions against penalties as set forth in *Dunlop* have thus been superseded in a manner divergent from the American tests that evolved over time, as discussed in the Section III below.

16) Paul Samuel Reinsch, *English Common Law in the Early American Colonies* 8 (Da Capo Press 1970).
17) Farnsworth, *supra* note 2, at 936.
18) The Restatement (First) of Contracts (1932).
19) Farnsworth, *supra* note 2, at 25-26.

The American common law test to distinguish penalties from liquidated damages evolved into something similar to its English equivalent. While the test would eventually be refined by the Restatement (First) of Contracts as discussed below, American courts initially focused on three requirements necessary to separate an enforceable liquidated damages clause from an unenforceable penalty: 1) the intent of the parties was to create a mechanism to pay damages rather than a penalty; 2) the contemplated damages were presently unknown, or would be difficult to accurately predetermine; and 3) the amount was a reasonable estimate of these potential losses.[20]

1. Intent of the Parties

Opponents of invalidating duly agreed penalty provisions have argued in favor of enforcement because parties should have the freedom to contract as they choose, and the courts should not interfere with the details of mutually agreed terms and conditions of a deal. Experienced parties have the capacity and wherewithal to pick and choose among a multitude of damages, from the small to extraordinary, and reflect the risks and rewards associated therewith by appropriate pricing agreed to in the contract.[21] Common law courts, however, sought to prevent the use of contracts as a source of penalties against one party, holding such provisions void. When stipulated sums were not based on the principle of compensation, they would not be enforced. The parties' mutual statement in a written agreement that their "intention" for payment in the event of a contractual violation was not sufficient if not supported by an intent for true liquidated damages.[22]

The time to look at parties' intent was at the time of contract formation, rather than the actual effects at the time of a breach, as predetermined damages were not to exceed a reasonable estimate expected for a future breach determined at the time of contract formation. An agreement to pay stipulated damages not reasonably related to contemplated damages would be void.[23] The intent of the parties in estimating damages at the time of contract formation was to be measured not just by the words of the contract, but by the actual meaning behind them. For example, parties referring to a payment as a "penalty" could nevertheless find the terms upheld as liquidated damages,[24] while conversely, a clause that was clearly meant to serve as a penalty could not be enforced just because the payment was referred to as "liquidated damages" in an agreement. The importance of the parties' intent began to wane over time, as reflected in the First Restatement, which provided that damages predetermined at contract execution would not be enforceable unless "(a) the amount so fixed is a reasonable forecast of just compensation for the harm that is caused by

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20) Perillo, *supra* note 1, at 558.
21) Charles Fried, *Contract as Promise* 144 (2d ed., Oxford University Press 2015).
22) Muldoon v. Lynch, 66 Cal. 536, 539, 6 P. 417, 419 (1885).
23) Davy v. Crawford, 147 F.2d 574, 575 (D.C. Cir. 1945).
24) Tode v. Gross, 127 N.Y. 480, 28 N.E. 469 (1891).

the breach, and (b) the harm that is caused by the breach is one that is incapable or very difficult of accurate estimation."[25] The language eliminated the common law's explicit measure of "intent", but retained it as a characteristic of the other requirements. Even with this change to the test, courts would continue to look beyond the mere language of contracts to determine whether the parties were truly attempting to determine fair compensation for losses, or rather penalizing a party.

2. Damages Unknown or Difficult to Determine

The second common law requirement for evaluating liquidated damages was relatively less important than the third, though helpful for ensuring that the determination of reasonableness is met. The easier it is to estimate damages, the closer one would expect the predetermined amounts to meet the actual damages. As the difficulty of accurately estimating damages increases, the likelihood of liquidated damages later being held reasonable would also increase.[26] Liquidated damages would be upheld even if the actual damages could have been calculated. The main focus was traditionally on the reasonableness of the liquidated damages, as estimated at the time of the contract's execution.[27]

Situations when the loss was not only money but also included time and enjoyment were particularly appropriate for liquidated damages. In *Banta v. Stamford Motor Co.*,[28] a plaintiff contracted for the construction of a yacht for delivery by a fixed date. If delivery occurred before the set date, the plaintiff was to pay a $5 bonus per day of completion ahead of schedule. For each day delivery was delayed beyond the set date, the defendant was to pay $15 in liquidated damages. The defendant was almost three months late in delivery. Rental of a similar craft would have been approximately $15 per day, though the plaintiff did not in actuality rent a boat. The plaintiff wanted to cruise on his own craft, and was unable to do so at the planned time due to the delay. The court held that the "situation was such that the loss or injury to be anticipated from a breach and the extent of it would inevitably lie in the field of uncertainty and be difficult to prove, and that an attempt to measure it in the terms of dollars and cents would be beset by even greater difficulties."[29] The boat builder knew that timing was important to the buyer, especially as evidenced by

25) Restatement (First) of Contracts § 339(1) (1932). *See* Comment b, which states that "Contracts are frequently made in which performances of very different degrees of importance and value are promised and one large sum of money is made payable as damages for any breach whatever. Since such a contract promises the same reparation for the breach of a trivial or comparatively unimportant stipulation as for the breach of the most important one or of the whole contract, it is obvious that the parties have not adhered to the rule of just compensation. In this matter neither the intention of the parties nor their expression of intention is the governing consideration. The payment promised may be a penalty, though described expressly as liquidated damages, and vice versa."

26) Farnsworth, *supra* note 2, at 940.

27) Perillo, *supra* note 1, at 560.

28) Banta v. Stamford Motor Co., 89 Conn. 51, 55, 92 A. 665, 667 (1914).

29) *Id.*

the extra payments required by the purchaser for early delivery. Perhaps the buyer would not have executed the contract at all had he known about the delay beforehand. Additionally, the builder was not an unsophisticated party, stipulating to unknowable damages. The parties knew of the difficulty in predicting actual damages, and that was presumably why they agreed to each party's potential predetermined payments at the contract's execution. Finally, the terms and amounts were reasonable for the parties, in light of the circumstances, which is the third factor discussed below.

3. The Amount of Damages is a Reasonable Estimate

When determining reasonableness, parties needed to contemplate the connection between the liquidated damages and the actual anticipated breach. Traditionally, "shotgun" clauses that set a large amount for any breach, no matter how major or relatively inconsequential, were likely unenforceable. The broad application of such a payment indicated that it was not sufficiently tailored or calculated if it could apply to even the most minor of transgressions.[30] Such clauses were not enforced even if there was a genuine intent to create a liquidated damages clause, but the amount was disproportionate to the reasonably anticipated or actual damages.[31]

Similar to the English common law test established in *Dunlop*, the American common law courts were originally less concerned with the language used to define a payment as a penalty or liquidated damages, but more concerned with the actual effect. For example, the Supreme Court determined that a payment explicitly referred to in a contract as a "penalty" was in fact a reasonable estimate of potential loss, and thus enforceable liquidated damages. In the late nineteenth century, Bethlehem Steel agreed to supply gun carriages for the War Department under contract dated April 4, 1898 as part of anticipated hostilities against Spain.[32] Damages were to be assessed against the supplier for each day of delay by price reductions per unit. Contemporaneous correspondence between the government and supplier concerning contract details specifically called these deductions "penalties" on numerous occasions.

Delivery was ultimately delayed. While the parties disagreed as to the amount of delay caused by the supplier, the government attributed a total of six hundred days of aggregated delay to Bethlehem Steel. The contract provided for a reduction of $35 per day of delay, for a total "penalty" of $21,000 which was withheld from the remaining balance of $195,000 paid to the supplier.[33] However, the supplies would have been unusable due to the

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30) Farnsworth, *supra* note 2, at 943.

31) Perillo, *supra* note 1, at 559.

32) Spain declared war on the United States on April 23, 1898, and the U.S. Congress voted for war against Spain on April 25. Fighting continued until a cease-fire was signed on August 12 of the same year, with a formal end to the war by the Treaty of Paris on December 10, 1898. *See* Department of State, United States of America, Office of the Historian, *The Spanish-American War, 1898*, https://history.state.gov/milestones/1866-1898/spanish-american-war (accessed January 25, 2024).

33) United States v. Bethlehem Steel Co., 205 U.S. 105, 112-13, 27 S. Ct. 450, 453-54 (1907).

government's unpreparedness even if delivered as originally scheduled. To add insult to Bethlehem Steel's purported injury, the government was still unprepared to actually use the gun carriages at the time of their late delivery. No harm was caused to the government due to the late deliveries.[34)]

The Court held that references to a "penalty" were not "indicative of the technical and legal difference between penalty and liquidated damages" and that neither expression is always conclusive as to the meaning of the parties.[35)] The Court looked at the record to determine that the contracted $35 "penalty" was calculated based on an average of the price bid for slower delivery and the price agreed to by Bethlehem Steel. The Court looked beyond the mere forms and language used, to focus on the intent of the parties, holding that based on the evidence, the parties truly intended to create a liquidated damages provision, despite the term "penalty" being used. "This view is also strengthened when we recognize the great difficulty of proving damage in a case like this…"[36)] and thus constituted a reasonable estimate of damages at the time.

The Court looked at the facts as they existed at the time of the contract's execution, rather than at the time of the breach. The parties did not know that the war would end quickly when the contract was executed, and for all the parties knew at the time, even a single delay could have been of critical significance to the war effort. Damages suffered by the government could have been much higher. But the predetermined damages in the contract were "not so extraordinarily disproportionate to the damage which might result from the failure to deliver the carriages as to show that the parties must have intended a penalty, and could not have meant liquidated damages."[37)] As a result, the Court determined that the intent of the parties would take precedence over terms of art that did not accurately describe the intended effects of the contract,[38)] as they were reasonable under the circumstances.

In a similar case, Priebe & Sons contracted with the federal government to provide dried eggs bound for England and Russia under the Lend Lease Act. Delivery was due at a time chosen by the government within a fixed ten-day period from May 18, 1942, with an additional requirement that Priebe & Sons' failure to have the eggs inspected and ready by May 18 would incur liquidated damages. The government subsequently fixed the delivery

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34) *Id.* at 113, 454.

35) *Id.* at 120, 455.

36) *Id.* at 120, 455-56.

37) *Id.* at 121, 456.

38) The Connecticut Supreme Court in *Banta v. Stamford Motor Co.*, *supra* note 28, similarly summarized its focus not on the actual damages at the time of a breach, but at the reasonableness at the time the estimate was made. "It is the look forward, and not backward, that we are called upon to take, and the plaintiff is under no obligation to show actual damage suffered substantially commensurate" with the liquidated damages. *Id.* at 56, 667. This position would gradually shift over time, however, as exemplified by that same court's reinterpretation of this view just over fifty years later, in *Norwalk Door Closer Co. v. Eagle Lock & Screw Co.*, 153 Conn. 681, 689-90, 220 A.2d 263, 268 (1966), as referenced *infra* note 45.

date for May 26, and the supplier made timely delivery. The government, however, sought liquidated damages when it learned that the eggs were not inspected until May 22. The supplier claimed that the liquidated damage provision was an unreasonable penalty, as delivery was nonetheless made on time and in conformance with the contract quality requirements.[39] The Court noted that liquidated damages provisions are not disfavored when they are fair and reasonable estimates of just compensation for anticipated loss in the event of breach, and can be upheld even when actual damages are less than the predetermined liquidated damages. It held that such predetermined damages, as in *Bethlehem Steel*, must be reviewed as of the contract's execution.[40] Unlike the above case, however, the Court here rejected the validity of the agreed liquidated damages, noting that injury could only be caused by late delivery. Liquidated damages could be validly assessed if that was the case. "But under this procurement program delays of the contractors which did not interfere with prompt deliveries plainly would not occasion damage. That was as certain when the contract was made as it later proved to be."[41] The liquidated damages were thus held to be no reasonable estimate of actual damages, as no actual damages could be incurred under the clause as written, and the payments were therefore unenforceable penalties.

Just because no actual damages were incurred at the time of the breach did not mean that liquidated damages would necessarily be invalidated. In a similar example, Southwest Engineering Company entered into four construction contracts with the government. The projects included due dates and provided for liquidated damages for delayed completion. Each project was completed between 48 and 97 days late. However, the parties stipulated that no actual damage was incurred by the government as a result of the delays.[42] The court considered two factors in determining whether the liquidated damages would be enforceable or not: 1) the pre-fixed damages for a breach must be a reasonable estimate of fair compensation for its anticipated harm, and 2) the damages must be difficult or impossible to accurately estimate.[43] Unlike *Priebe & Sons*, the court found that the liquidated damages contemplated by the parties were a reasonable forecast of harm. If actual damages later turned out to be greater than the liquidated damages, the injured party would nonetheless be bound by the terms of the contract. It was thus also fair to hold the contractor equally responsible in the event actual damages were less than the liquidated damages to which they agreed. "Each party by entering into such contractual provision took a calculated risk and is bound by reasonable contractual provisions pertaining to liquidated damages."[44]

While the majority of early common law court decisions focused on the reasonableness

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39) Priebe & Sons, Inc. v. United States, 332 U.S. 407, 409-10, 68 S. Ct. 123, 124-25 (1947).
40) *Id.* at 411-12, 126 (citations omitted).
41) *Id.* at 412-13, 126 (citations omitted).
42) Sw. Eng'g Co. v. United States, 341 F.2d 998, 999-1000 (8th Cir. 1965).
43) *Id.* at 1001.
44) *Id.* at 1003.

of the liquidated damages at the time of the contract, not all courts agreed with this decision. The divergence can be seen in *Norwalk Door Closer Co. v. Eagle Lock & Screw Co.*,[45] where the Connecticut Supreme Court held that consideration of actual damages (or a lack thereof) at the time of a breach was also an important consideration in categorizing payments as penalties versus liquidated damages. A manufacturing agreement provided that if defendant terminated the contract, plaintiff could deem this a breach resulting in $100,000 in liquidated damages. However, a third company took over the defendant's assets and production of goods, resulting in no actual losses to the plaintiff. As a result, the court refused to enforce the liquidated damages. While parties are allowed to estimate reasonably foreseeable damages in a liquidated damages clause, if no harm actually occurs, the purpose of the original estimate is obviated. The enforcement itself would effectively serve as a penalty at the expense of justice and the parties' original intent.[46] This approach of examining the reasonableness of damages from both the time of the contract's execution as well as the time of the breach represented a shift that would be codified as part of Article 2 of the Uniform Commercial Code.

B. The Uniform Commercial Code and the Second Restatement of Contracts

The American Law Institute and the National Conference of Commissioners on Uniform State Laws began preparing the Uniform Commercial Code ("UCC") in 1942 in an attempt to harmonize the continuing differences among state business laws. The first official text was published in 1952, with subsequent revisions promulgated thereafter. All states except for Louisiana[47] enacted a version of Article 2 (Sales) of the UCC by 1967. The non-American practitioner should note that Article 2 of the UCC itself is not a national law, but a model law for states to consider adopting. While forty-nine of the fifty states did codify Article 2 of the UCC legislatively, many incorporated their own local deviations from the model code, so a level of caution is required in practice to check with the applicable state statute as enacted, rather than the model code.[48]

Section 718(1) of UCC Article 2 directly addresses liquidated damages as follows: "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

45) Norwalk Door Closer Co. v. Eagle Lock & Screw Co., 153 Conn. 681, 220 A.2d 263 (1966).

46) *Id.* at 689-90, 268.

47) Louisiana maintains its civil code governing sales, though it too has been influenced by the common law and the UCC. *See* La. C.C. Art. 2438 - 2659. *See also* Christian Paul Callens, *Louisiana Civil Law and the Uniform Commercial Code: Interpreting the New Louisiana U.C.C.-Inspired Sales Articles on Price*, 69 Tul. L. Rev. 1649 (1995).

48) *See* Bradford Stone and Kristen David Adams, *Uniform Commercial Code in a Nutshell*, XII-XIII (8th ed., West Publishing Co., 2012) and Joseph M. Perillo, *Contracts* 16 (7th ed., West Academic Publishing 2014).

obtaining an adequate remedy. A term fixing unreasonably large liquidated damages is void as a penalty."[49] The majority of courts interpret this to mean that liquidated damages are enforceable if they are reasonable regarding either the anticipated harm, *or* the actual harm. Some courts, however, require a showing that the liquidated damages are proportionate to both the anticipated harm and the actual harm. Thus, a defendant could possibly have a claim for liquidated damages disregarded if the actual harm proved to total a lesser amount than as provided in a reasonably contemplated liquidated damages clause.[50]

In the wake of the UCC's success, the Restatement of Contracts was revised in a second edition published in 1981 in order to align more closely with the principles of the UCC. Like the original Restatement, the revision is not binding statutory law, but carries great persuasive authority. Section 356(1) of the Restatement (Second) of Contracts mirrors the UCC by providing: "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."[51] While not substantively different from the UCC, the Restatement provides the advantage of comments and illustrations to provide additional clarity for courts and practitioners. In practice, courts will often cite the UCC, the Restatement, or both, when tasked with determining the validity of liquidated damages provisions. Even when a contract does not specifically involve an agreement for the sale of goods, the principles of the UCC may nevertheless be referenced in conjunction with the Restatement as authoritative. The rationale is twofold. "First, § 356(1) aligns with UCC § 2-718(1)… Thus, courts can apply the same test to both UCC-governed and non-UCC-governed contracts. Second, the test best accommodates the goal of compensating the non-breaching party for a loss rather than penalizing the breaching party."[52] The equitable principles of both authorities and related case law complement each other when analyzing the requirements of UCC § 2-718(1) in determining the validity of liquidated damages, and thus provide courts with flexibility to uphold predetermined damages while also preventing the imposition of penalties.

1. Reasonableness Regarding Anticipated or Actual Harm

Unlike the old common law precedent, the UCC foregoes an examination of the intent of the obligor and obligee. Instead of a subjective look into the minds of the parties, "liquidated damage clauses are allowed where the amount involved is reasonable in the light

49) Unif. Commercial Code § 2-718(1).

50) *See* Susan V. Ferris, *Liquidated Damages Recovery Under the Restatement (Second) of Contracts*, 67 Cornell L. Rev. 862, 871-72 (1982).

51) Restatement (Second) of Contracts § 356 (1981).

52) Dobson Bay Club II DD, LLC v. La Sonrisa de Siena, LLC, 242 Ariz. 108, 111-12, 393 P.3d 449, 452-53 (2017).

of the circumstances of the case." The UCC "sets forth explicitly the elements to be considered in determining the reasonableness of a liquidated damage clause."[53] In *Stock Shop v. Bozell*,[54] a notable application of this test, a defendant received forty photos from the plaintiff to be used for licensing purposes, but at the end of use, thirty-nine originals were not returned. The plaintiff argued for damages to be assessed at a value of at least $1, 500 per photo, as a delivery memo between the parties provided that damages for unreturned originals were to be based on each photograph's value, but "the reasonable minimum value… shall be no less than fifteen hundred ($1,500.00) dollars."[55] In other words, a floor for potential damages was set, with no ceiling. The court turned its attention not to industry standards at the time, but to the "reasonableness" of the liquidated damages under UCC § 2-718(1) as to the harm anticipated at the time of contract execution, or actual harm at the breach.[56] The court was not impressed by the flat payment system assessed to dozens of different photos of varying marketability, which did not reflect any semblance of actual value of the prints. Because the liquidated damages were "not reasonable with respect to the anticipated *or* actual harm" they were determined to be unenforceable, as this clause "would allow the plaintiff to have its cake and eat it too."[57] Allowing a party to pick and choose from alternative amounts to collect upon a breach belies the presumption of reasonableness.[58]

Reasonableness sometimes also requires the court to look at the overall picture, which may involve a third party affecting a delay. In *California and Hawaiian Sugar Co. v. Sun Ship, Inc.*, the plaintiff ("C and H") commissioned two manufacturers to produce two parts of a vessel to be assembled for the shipment of sugar from Hawaii to California. Both manufacturers were delayed, and the vessel could not be completed until both sections were delivered. C and H settled with one of the manufacturers, but brought its case against Sun

53) Unif. Commercial Code § 2-718 Official Comments (1).

54) Stock Shop, Inc. v. Bozell & Jacobs, Inc., 126 Misc. 2d 95, 481 N.Y.S.2d 269 (Sup. Ct. 1984).

55) *Id.* at 95, 270.

56) *Id.* at 97, 270-71.

57) *Id.* at 98, 271, quoting Dalston Constr. Corp. v. Wallace, 26 Misc.2d 698, 699-700, 214 N.Y.S.2d 191, 193 (Dist. Ct. Nassau Co., 2d Dist. 1960).

58) A distinction from the *Stock Shop* holding was made where a liquidated damages clause also provided for a determination of payments between two values. In *International Marine LLC v. FDT, LLC*, No. CIV. A. 10-0044, 2014 WL 7240143 at 7 (E.D. La. Dec. 19, 2014), a liquidated damages clause provided for damages to be calculated as "the *greater of* (i) the sum of Two Hundred Fifty Thousand and no/100 Dollars ($250,000.00) per incident or occurrence or (ii) if applicable the gross amount of revenue earned in violation of such covenant and agreement with respect of the incident or occurrence in question…" Unlike *Stock Shop*, however, the court held that the provision here provided no option for the injured party to pick and choose damages. "Rather, resolution of damages simply involves a mathematical formula: a breach automatically triggers liquidated damages of $250,000 per breach *unless* the gross revenue earned for the violation is greater than $250,000… [T]he plain language of the clause is accurate: the $250,000 sum exists because actual damages are difficult to ascertain here." Intl. Marine at 7. This is in contrast to *Stock Shop*'s language that was not connected to estimated damages, and gave the plaintiff the right to affirmatively choose taking the liquidated damages or proving actual damages.

Ship to collect liquidated damages for its part of the delay. The sales contract provided for Sun Ship to pay $17,000 each day that delivery was delayed beyond June 30, 1981, described in the contract "as per-day liquidated damages, and not as a penalty" and "a reasonable measure of the damages".[59] The amount was well-considered by the parties, in light of anticipated losses from a potential failure to transport the plaintiff's sugar crop in a timely manner at peak season. In fact, though Sun Ship's vessel was not ready until March 16, 1982, C and H was able to secure alternate shipping of their crop, resulting in few actual damages. Under such circumstances, Sun Ship argued that the more than $4 million liquidated damages accrued would therefore be a penalty.[60] The court was not persuaded. "Proof of this loss is difficult—as difficult, perhaps, as proof of loss would have been if the sugar crop had been delivered late because shipping was missing. Whatever the loss, the parties had promised each other that $17,000 per day was a reasonable measure. The court must decline to substitute the requirements of judicial proof for the parties' own conclusion."[61] The business decision of the two sophisticated parties to set reasonably estimated liquidated damages at the time of the contract execution was upheld. Thus, while the size of the actual loss is a major factor to consider against the others in determining the reasonableness of liquidated damages, it is not solely determinative.

2. Difficulty of Proof of Loss

Although not many cases focus on the aspect of difficulty of proof of loss under the UCC elements of a liquidated damages analysis, a few present indications of the proper considerations. In *Kapunakea Partners v. Equilon Enterprises*,[62] plaintiffs entered into retail sales and recapture agreements with Shell Oil Products U.S. The recapture agreements directed that Shell provide the plaintiffs with funds for improvements at their gas stations in exchange for their agreement to purchase minimum amounts of gasoline. The recapture agreements included liquidated damages in the event of breach, with language providing that "[s]uch damages will be extremely difficult and impracticable to determine. In addition, both parties wish to avoid the time and expense of protracted litigation that would result if Company filed a lawsuit to collects [sic] its damages for breach of [the Recapture] Agreement."[63] Plaintiffs claimed that they properly terminated the contract per its terms, and were not subject to the liquidated damages. In any event, they asserted that the liquidated damages provisions were not related to Shell's actual damages, which were not difficult to estimate at the time the Agreements were executed. On this point, the court

59) California and Hawaiian Sugar Co. v. Sun Ship, Inc., 794 F.2d 1433, 1435 (9th Cir. 1986), opinion amended on denial of reh'g, 811 F.2d 1264 (9th Cir. 1987).

60) *Id.* at 1436.

61) *Id.* at 1439.

62) Kapunakea Partners v. Equilon Enterprises LLC, 679 F. Supp. 2d 1203 (D. Haw. 2009).

63) *Id.* at 1206.

agreed, holding the provisions void and unenforceable penalties.[64)]

If damages can be easily predetermined, there seems to be little need for an alternative amount to be considered and reflected as liquidated damages. In a matter involving a limited partnership agreement, the Supreme Court of Texas considered a liquidated damages provision that would provide ten times the losses resulting from a breach. The court found this an unenforceable penalty, without even having to consider the reasonableness of the terms. There was no difficulty or impossibility of estimating the harm of a breach. In fact, the terms of the provision required actual damages to first be calculated, with the damage multiplier applied thereafter.[65)] That, in and of itself, demonstrated an abject lack of difficulty in proving loss, abrogating the need for liquidated damages provisions.

3. The Inconvenience or Nonfeasibility of Obtaining an Adequate Remedy

Like the prior test of “difficulties of proof of loss”, the “inconvenience or nonfeasibility of obtaining an adequate remedy” has relatively little case law primarily determinative on this factor. In a case involving the supply of 90,000 metric tons of biofuel, the purchaser failed in its purchasing obligations and argued that being forced to pay carrying costs for goods not purchased amounted to a penalty. The court disagreed, holding that “carrying costs are not an estimate of shipping costs; rather, they are the costs of continuing to hold material after the buyer should have taken possession…” An expert witness at trial testified that carrying cost calculations are “messy and just terrible, so people agree [to] pick a number… that’s about right to cover most of the damages.”[66)] The carrying costs were thus held to be a reasonable estimate of damages, rather than a penalty, due to the innumerable permutations of possible damage calculations. While this consideration is also a “difficulty in proving loss”, the additional unknown variables likely made this decision to validate the liquidated damages much easier for the court.

4. Unreasonably Large Liquidated Damages

The common law principally focused on the reasonableness of the liquidated damages as estimated by the parties at the time of contracting. As mentioned above, the UCC requires that the parties’ consideration of liquidated damages must be “reasonable in the light of the anticipated *or actual harm* caused by the breach”,[67)] adding to the old common law test a second time when reasonableness must be considered. More recent case law exemplifies this updated standard.

Garden Ridge stores sold housewares and home goods. Advance International accepted

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64) *Id*. at 1214.

65) Phillips v. Phillips, 820 S.W.2d 785, 788-89 (Tex. 1991).

66) LifeTree Trading Pte., Ltd. v. Washakie Renewable Energy, LLC, No. 14-CV-9075 (JPO), 2018 WL 2192186 at 8 (S.D.N.Y. 2018) (internal citations omitted).

67) Unif. Commercial Code § 2-718(1) (emphasis added).

two purchase orders from them prior to the Christmas holiday season, one for 950 nine-foot tall waving snowmen, and the other for 3,500 eight-foot tall waving snowmen, to be sold at retail. Five days before a promotional sale at their stores was to begin, Garden Ridge realized that the eight-foot snowmen it received were snowmen similar to those ordered, except that they were a model that did not wave. While both versions sold well, Garden Ridge nevertheless sought to collect liquidated damages as provided for breaches under their agreement. Garden Ridge admitted that it made the same profit as it would have if no delivery error was made.[68]

To determine if liquidated damages are unreasonably large, actual harm is a factor requiring consideration in comparison to the predetermined payments, as both the UCC and common law permit such review.[69] In holding the liquidated damages provisions unenforceable as penalties under the UCC because they fixed unreasonably large penalties, the court noted that the potential harm from the receipt of nonconforming goods was not difficult to estimate at the time of contract formation, no attempt was made to set an amount that was reasonable in consideration of anticipated or actual harm, and Garden Ridge demonstrated no actual damages from the breach.[70] While the lack of demonstrable damages was an important factor, it alone was not determinative. The fact that damages were fixed at a set rate for any and all breaches, no matter how large or immaterial, also weighed against enforcement of upholding the liquidated damages. The court noted that Garden Ridge could have assessed full liquidated damages in the event of a non-material breach as small as a substitution of the color of the snowmen's buttons. This unfettered discretion not only failed to reasonably reflect anticipated harm from a breach, but would be unreasonably and disproportionately large in the event of a non-material breach.[71]

The tests for determining the validity of liquidated damages clauses may concern those who favor the "right to contract" among informed parties, as it may seem that the courts are often predisposed to classify liquidated damages as penalties. This is not necessarily so. As an example, in a contract for the sale of two cooperative apartments in New York, a purchaser sued the seller for a return of two $5,000 deposits. The purchaser made successful bids for two separate units and paid the deposit money for each, but failed to complete the purchase of the clearly advertised "as is" units after subsequently discovering unpaid liens against the property.[72] The court referenced the requirements of UCC § 2-718 and noted that the statute allows reasonable liquidated damages. The two $5,000 deposits were for

68) Garden Ridge, L.P. v. Advance Intl., Inc., 403 S.W.3d 432, 434-36 (2013).
69) *Id.* at 440.
70) *Id.* at 440-41.
71) *Id.* at 441-42.
72) Moutopoulis v. 2075–2081 Wallace Ave. Owners Corp., 47 Misc. 3d 1049, 1050, 10 N.Y.S.3d 823, 825 (N.Y. Civ. Ct. 2015). Cooperative apartments in New York are exchanged through the sale of shares of stock, and are thus considered personal property, to be governed by Article 2 of the UCC. *Id.* at 1053-54, 827-28.

properties to be sold for $50,000 and $47,000 respectively. In light of the circumstances, the amounts of the deposits to be withheld as liquidated damages were held to be not so unreasonably large as to be void as penalties.[73] Had the condition of the property been erroneously advertised, or if the amounts of liquidated damages were out of line with industry standards for similar transactions, perhaps the outcome would have been different. The court, however, had no issue enforcing a liquidated damages clause that conformed with the "reasonable" requirement of the UCC. While not always an easy determination, separating reasonable liquidated damages from onerous penalties allows for an equitable balance between the right of parties to freely contract while simultaneously preventing inequities that would otherwise result from an unbending enforcement of provisions agreed to long before actual breaches occur.

If the courts are mindful to invalidate excessively large liquidated damages as penalties, it stands to reason that the inverse would be true in the event the liquidated damages were much less than the actual losses. The official comments the UCC provide that "[a]n unreasonably small amount would be subject to similar criticism and might be stricken under the section on unconscionable contracts or clauses."[74] Note that the comment does not state that such provision would be "void", but "unconscionable". The distinction was notable in a case involving a sales and distribution agreement when Action Orthopedics executed an exclusive distributorship agreement with Techmedica, a manufacturer of customized orthopedic prostheses and related goods. After the manufacturer terminated the agreement for cause, Action Orthopedics sued for, among other claims, breach of contract and sought damages for loss of expected earnings and diminution of its business value. Techmedica countered that the contract's liquidated damages provision precluded payment for such losses, which were not ascertainable as of the date the contract was executed. The distributorship agreement set liquidated damages at the lesser of five percent of the past year's gross sales or flat sum of $50,000. Applying the math to the sales resulted in liquidated damages of approximately $6,500 which was much less than the ceiling set by the clause. The court noted that the UCC voids unreasonably large liquidated damages as penalties. "By negative implication, while a clause fixing unreasonably small liquidated damages may be invalid, it is not void as a penalty. In other words, a liquidated damages clause is void as a penalty only in regard to the party required to pay, not the payee."[75] As Action Orthopedics could not have the liquidated damages clause thrown out, and it did not plead unconscionability in its claim, the court upheld the limited damages.[76]

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73) *Id.* at 1056-57, 829-30.

74) Unif. Commercial Code § 2-718 Official Comments (1).

75) Action Orthopedics, Inc. v. Techmedica, Inc., 759 F. Supp. 1566, 1570 (M.D. Fla. 1991).

76) Comment d in the Restatement (Second) of Contracts § 356 (1981) notes that damages in "an amount that is unreasonably small does not come within the rule stated in this Section, but a court may refuse to enforce it as unconscionable…" In this light, the holding in *Action Orthopedics* may have been different had the plaintiff specifically made a claim for unconscionability. Lobianco v. Prop. Prot., Inc., 292 Pa. ↗

IV. Conclusion

Contracts are effective tools for the efficient enforcement of promises. Their goal should be limited to the business of business rather than punitive purposes. Properly drafted liquidated damages clauses may provide some protection for a party's duly anticipated losses, and not act as a type of bonus payment that places a party in an improved position because of a breach. For example, such clauses cannot permit a party to collect liquidated damages while also providing the same individual an option to sue for actual damages instead.[77] In other words, double dipping is not allowed and reasonableness is the overarching ideal. The standards of reasonableness that are required to assess the validity of any liquidated damages provision render it impossible to provide the courts with a singular checklist suitable for measuring adherence to the statutory provisions of UCC § 2-718(1) across the board in all cases and in all jurisdictions. This is, however, arguably a merit of the standards, rather than a flaw. The statute requires courts to consider the concept of overall fairness of the predetermined payments case by case relative to the intent at the time of the contract, as well as the realities that subsequently developed.

Ultimately, the test for determining the validity of liquidated damages is clearer with the use of the statutory guidance under the UCC, but it is not always a straightforward matter. It may be argued that predetermined payments at the time of contract formation should never be subject to judicial review if the parties chose to agree to those provisions. Parties may believe they will encounter "difficulty" in proving actual loss at a future time, even in a straightforward sales agreement. Furthermore, breaches create costs in terms of convenience, time and enjoyment that cannot be easily demonstrated by mathematical calculations.

The UCC broke from the common law test that limited the review of reasonableness to the time that the contract was made, in order to permit an analysis of not just anticipated, but also actual harm. With the benefit of hindsight, however, can judges reliably determine if parties made a "reasonable" estimate of damages when analyzing the result of a breach, as they now have information that was impossible to know at the time that the contract was formed? "Hindsight bias" can result in a court overestimating just how narrowly a party

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↘ Super. 346, 437 A.2d 417 (1981) presented a somewhat similar situation but with different reasoning in the opinion. A customer sued a security system provider after her jewelry was stolen due to the failure of the alarm. The value of stolen property was $35,815, but the contract limited liability to repair or replacement of the alarm system, and specifically excluded loss or damage to possessions. The majority opinion focused on UCC § 2-719(c) and 2-316(2) in upholding the limitation on liability. The dissenting opinion, however, believed that § 2-718 should have been applied, with consideration given to the fact that the damages could be unreasonably too small.

77) Narrowly applying the liquidated damages is a helpful sign for a court to view the pre-agreed payments as enforceable liquidated damages, as they would be targeted to a more specific category of damages, rather than being seen as a one-size-fits-all approach to damages, as indicative of a penalty.

could have calculated then-undetermined damages.[78] From this perspective, one could argue that the old common law approach was the fairer position, given that contract law cannot expect clairvoyance on the part of contracting parties, and their mutual agreement for future damages should thus receive less judicial scrutiny. After all, if parties have the freedom to contract and an agreed amount is reasonable at the time of the contract, a court should not become involved merely because the amount is deemed "unreasonable" at the time of trial. Comments to the Restatement (Second) of Contracts § 356 (1981) state that when no clear loss at all has occurred, "a provision fixing a *substantial* sum as damages is unenforceable."[79] Yet an Illustration to the same Comment gives an example of a delay that causes the other party no harm whatsoever, and agreed-to daily liquidated damages would be "unenforceable on grounds of public policy."[80] The illustration does not differentiate as to whether the liquidated damages were "substantial" or not. As such distinctions are not always straightforward, judicial review is relatively easier but no less necessary than before the adoption of the UCC.

Courts are often tasked with delineating the "fuzzy line between penalty clauses and liquidated-damages clauses."[81] While at times a daunting endeavor, a prohibition against penalty clauses helps avoid inequitable results by looking at the reasonableness of circumstances at the time of contracting as well as the time of breach. Further, the prohibition of penalties serves as a disincentive for contracting parties with disproportionately greater bargaining power from pushing through inequitable penalty clauses for no other reason than because they are able to do so. By focusing on compensation for breaches rather than punitive retribution, the UCC, the Restatement, and related case law provide the flexibility necessary for the fair and reasonable estimates of damages, where circumstances present difficulties in calculating actual damages. The method may not be perfect, but the process developed between the old common law and the modern requirements enacted under the UCC provide balance between just compensation and inequitable frustration.

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78) "If, for example, there were a one percent possibility that substantial damage would occur in the case of breach and then that event actually occur[r]ed, the hindsight bias could lead the judge to think that there was a twenty percent chance." Enrico Baffi, *Efficient Penalty Clauses with Debiasing: Lessons from Cognitive Psychology*, 47 Val. U. L. Rev. 993, 997 (2013).

79) Restatement (Second) of Contracts § 356, Comment b (1981) (emphasis added).

80) *Id*. at Illustration 4.

81) Lake River Corp. v. Carborundum Co., 769 F.2d 1284, 1286 (7th Cir. 1985).