

Liquidated Damages and Attorneys' Fees

In some circumstances, parties prefer to define damages in the case of breach. A clause setting damages is called a “liquidated damages” clause. The purpose of such a clause is to pre-determine or liquidate damages in advance, presumably avoiding the need for a court or jury to determine damages after breach. But courts will refuse to enforce a liquidated damages clause if the damages specified are so severe and disproportionate that they constitute a penalty. Parties might also agree in advance that a breaching party will pay attorneys’ fees. As with liquidated damages clauses, courts may refuse to enforce an attorneys’ fees clause on the ground that the fees specified are punitive.

Lake River Corp. v. Carborundum Co.

769 F.2d 1284 (7th Cir. 1985)

POSNER, Circuit Judge.

This diversity suit between Lake River Corporation and Carborundum Company requires us to consider questions of Illinois commercial law, and in particular to explore the fuzzy line between penalty clauses and liquidated-damages clauses.

Carborundum manufactures “Ferro Carbo,” an abrasive powder used in making steel. To serve its midwestern customers better, Carborundum made a contract with Lake River by which the latter agreed to provide distribution services in its warehouse in Illinois. Lake River would receive Ferro Carbo in bulk from Carborundum, “bag” it, and ship the bagged product to Carborundum’s customers. The Ferro Carbo would remain Carborundum’s property until delivered to the customers.

Carborundum insisted that Lake River install a new bagging system to handle the contract. In order to be sure of being able to recover the cost of the new system (\$89,000) and make a profit of 20 percent of the contract price, Lake River insisted on the following minimum-quantity guarantee:

In consideration of the special equipment [i.e., the new bagging system] to be acquired and furnished by LAKE–RIVER for handling the product, CARBORUNDUM shall, during the initial three-year term of this Agreement, ship to LAKE–RIVER for bagging a minimum quantity of [22,500 tons]. If, at the end of the three-year term, this minimum quantity shall not have been shipped, LAKE–RIVER shall invoice CARBORUNDUM at the then

prevailing rates for the difference between the quantity bagged and the minimum guaranteed.

If Carborundum had shipped the full minimum quantity that it guaranteed, it would have owed Lake River roughly \$533,000 under the contract.

After the contract was signed in 1979, the demand for domestic steel, and with it the demand for Ferro Carbo, plummeted, and Carborundum failed to ship the guaranteed amount. When the contract expired late in 1982, Carborundum had shipped only 12,000 of the 22,500 tons it had guaranteed. Lake River had bagged the 12,000 tons and had billed Carborundum for this bagging, and Carborundum had paid, but by virtue of the formula in the minimum-guarantee clause Carborundum still owed Lake River \$241,000 – the contract price of \$533,000 if the full amount of Ferro Carbo had been shipped, minus what Carborundum had paid for the bagging of the quantity it had shipped.

When Lake River demanded payment of this amount, Carborundum refused, on the ground that the formula imposed a penalty. At the time, Lake River had in its warehouse 500 tons of bagged Ferro Carbo, having a market value of \$269,000, which it refused to release unless Carborundum paid the \$241,000 due under the formula. Lake River did offer to sell the bagged product and place the proceeds in escrow until its dispute with Carborundum over the enforceability of the formula was resolved, but Carborundum rejected the offer and trucked in bagged Ferro Carbo from the East to serve its customers in Illinois, at an additional cost of \$31,000.

Lake River brought this suit for \$241,000, which it claims as liquidated damages. Carborundum counterclaimed for the value of the bagged Ferro Carbo when Lake River impounded it and the additional cost of serving the customers affected by the impounding....

The hardest issue in the case is whether the formula in the minimum-guarantee clause imposes a penalty for breach of contract or is merely an effort to liquidate damages.... The clause here enhanced Carborundum's credibility in promising to ship the minimum amount guaranteed by showing that it was willing to pay the full contract price even if it failed to ship anything....

[S]ince compensatory damages should be sufficient to deter inefficient breaches (that is, breaches that cost the victim more than the gain to the contract breaker), penal damages could

have no effect other than to deter some efficient breaches. But this overlooks the earlier point that the willingness to agree to a penalty clause is a way of making the promisor and his promise credible and may therefore be essential to inducing some value-maximizing contracts to be made. It also overlooks the more important point that the parties (always assuming they are fully competent) will, in deciding whether to include a penalty clause in their contract, weigh the gains against the costs – costs that include the possibility of discouraging an efficient breach somewhere down the road – and will include the clause only if the benefits exceed those costs as well as all other costs.

On this view the refusal to enforce penalty clauses is (at best) paternalistic – and it seems odd that courts should display parental solicitude for large corporations. But however this may be, we must be on guard to avoid importing our own ideas of sound public policy into an area where our proper judicial role is more than usually deferential. The responsibility for making innovations in the common law of Illinois rests with the courts of Illinois, and not with the federal courts in Illinois. And like every other state, Illinois, untroubled by academic skepticism of the wisdom of refusing to enforce penalty clauses against sophisticated promisors, see, e.g., Goetz & Scott, *Liquidated Damages, Penalties and the Just Compensation Principle*, 77 COLUM. L. REV. 554 (1977), continues steadfastly to insist on the distinction between penalties and liquidated damages. To be valid under Illinois law a liquidation of damages must be a reasonable estimate at the time of contracting of the likely damages from breach, and the need for estimation at that time must be shown by reference to the likely difficulty of measuring the actual damages from a breach of contract after the breach occurs. If damages would be easy to determine then, or if the estimate greatly exceeds a reasonable upper estimate of what the damages are likely to be, it is a penalty. See, e.g., *M.I.G. Investments, Inc. v. Marsala*, 92 Ill. App. 3d 400, 405–06 (1981).

The distinction between a penalty and liquidated damages is not an easy one to draw in practice but we are required to draw it and can give only limited weight to the district court's determination. Whether a provision for damages is a penalty clause or a liquidated-damages clause is a question of law rather than fact....

Mindful that Illinois courts resolve doubtful cases in favor of classification as a penalty, we conclude that the damage formula in this case is a penalty and not a liquidation of damages, because it is designed always to assure Lake River more than its actual damages. The formula – full contract price minus the amount already invoiced to Carborundum – is invariant to the gravity of the breach. When a contract specifies a single sum in damages for any and all

breaches even though it is apparent that all are not of the same gravity, the specification is not a reasonable effort to estimate damages; and when in addition the fixed sum greatly exceeds the actual damages likely to be inflicted by a minor breach, its character as a penalty becomes unmistakable. [Citations omitted.] This case is within the gravitational field of these principles even though the minimum-guarantee clause does not fix a single sum as damages.

Suppose to begin with that the breach occurs the day after Lake River buys its new bagging system for \$89,000 and before Carborundum ships any Ferro Carbo. Carborundum would owe Lake River \$533,000. Since Lake River would have incurred at that point a total cost of only \$89,000, its net gain from the breach would be \$444,000. This is more than four times the profit of \$107,000 (20 percent of the contract price of \$533,000) that Lake River expected to make from the contract if it had been performed: a huge windfall.

Next suppose (as actually happened here) that breach occurs when 55 percent of the Ferro Carbo has been shipped. Lake River would already have received \$293,000 from Carborundum. To see what its costs then would have been (as estimated at the time of contracting), first subtract Lake River's anticipated profit on the contract of \$107,000 from the total contract price of \$533,000. The difference – Lake River's total cost of performance – is \$426,000. Of this, \$89,000 is the cost of the new bagging system, a fixed cost. The rest (\$426,000 – \$89,000 = \$337,000) presumably consists of variable costs that are roughly proportional to the amount of Ferro Carbo bagged; there is no indication of any other fixed costs. Assume, therefore, that if Lake River bagged 55 percent of the contractually agreed quantity, it incurred in doing so 55 percent of its variable costs, or \$185,000. When this is added to the cost of the new bagging system, assumed for the moment to be worthless except in connection with the contract, the total cost of performance to Lake River is \$274,000. Hence a breach that occurred after 55 percent of contractual performance was complete would be expected to yield Lake River a modest profit of \$19,000 (\$293,000 – \$274,000). But now add the “liquidated damages” of \$241,000 that Lake River claims, and the result is a total gain from the breach of \$260,000, which is almost two and a half times the profit that Lake River expected to gain if there was no breach. And this ignores any use value or salvage value of the new bagging system, which is the property of Lake River – though admittedly it also ignores the time value of money; Lake River paid \$89,000 for that system before receiving any revenue from the contract.

To complete the picture, assume that the breach had not occurred till performance was 90 percent complete. Then the “liquidated damages” clause would not be so one-sided, but it would be one-sided. Carborundum would have paid \$480,000 for bagging. Against this, Lake River would have incurred its fixed cost of \$89,000 plus 90 percent of its variable costs of \$337,000, or \$303,000. Its total costs would thus be \$392,000, and its net profit \$88,000. But

on top of this it would be entitled to “liquidated damages” of \$53,000, for a total profit of \$141,000 – more than 30 percent more than its expected profit of \$107,000 if there was no breach.

The reason for these results is that most of the costs to Lake River of performing the contract are saved if the contract is broken, and this saving is not reflected in the damage formula. As a result, at whatever point in the life of the contract a breach occurs, the damage formula gives Lake River more than its lost profits from the breach – dramatically more if the breach occurs at the beginning of the contract; tapering off at the end, it is true. Still, over the interval between the beginning of Lake River’s performance and nearly the end, the clause could be expected to generate profits ranging from 400 percent of the expected contract profits to 130 percent of those profits. And this is on the assumption that the bagging system has no value apart from the contract. If it were worth only \$20,000 to Lake River, the range would be 434 percent to 150 percent.

With the penalty clause in this case compare the liquidated-damages clause in *Arduini v. Board of Education, supra*, which is representative of such clauses upheld in Illinois. The plaintiff was a public school teacher whose contract provided that if he resigned before the end of the school year he would be docked 4 percent of his salary. This was a modest fraction of the contract price. And the cost to the school of an untimely resignation would be difficult to measure. Since that cost would be greater the more senior and experienced the teacher was, the fact that the liquidated damages would be greater the higher the teacher’s salary did not make the clause arbitrary. Even the fact that the liquidated damages were the same whether the teacher resigned at the beginning, the middle, or the end of the school year was not arbitrary, for it was unclear how the amount of actual damages would vary with the time of resignation. Although one might think that the earlier the teacher resigned the greater the damage to the school would be, the school might find it easier to hire a replacement for the whole year or a great part of it than to bring in a replacement at the last minute to grade the exams left behind by the resigning teacher. Here, in contrast, it is apparent from the face of the contract that the damages provided for by the “liquidated damages” clause are grossly disproportionate to any probable loss and penalize some breaches much more heavily than others regardless of relative cost.

The fact that the damage formula is invalid does not deprive Lake River of a remedy. The parties did not contract explicitly with reference to the measure of damages if the agreed-on damage formula was invalidated, but all this means is that the victim of the breach is entitled to his common law damages. See, e.g., Restatement (Second) of Contracts § 356, Comment a (1981).^{*} In this case that would be the unpaid contract price of \$241,000 minus the costs that Lake River saved by not having to complete the contract (the variable costs on the other 45 percent of the Ferro Carbo that it never had to bag). The case must be remanded to the district judge to fix these damages.

The judgment of the district court is affirmed in part and reversed in part, and the case is returned to that court to redetermine both parties' damages in accordance with the principles in this opinion. The parties may present additional evidence on remand, and shall bear their own costs in this court. Circuit Rule 18 shall not apply on remand.

AFFIRMED IN PART, REVERSED IN PART, AND REMANDED.

Notes and Questions

1. Chief Judge Posner speaks with some disapproval of the rationale for refusing to enforce liquidated damages when they amount to a penalty. Why should courts care whether the parties agree to a remedy that “penalizes” a breaching party? What public policy goal is served by disallowing such a provision?
2. In the film *Mad Max: Beyond Thunderdome* (Warner Bros. Pictures 1985), the titular character breaches a contract and the penalties are determined by a spin of a wheel. Potential consequences include death, hard labor, forfeiture of goods, and amputation. Faced with such outcomes, a party might be unduly discouraged from breaching a contract.

Consider the following hypothetical: Holiday has two sources of income, lawn mowing and the occasional brain surgery. She's a talented surgeon facing occasional demand. She's scheduled to mow Armstrong's lawn this afternoon, but Reinhardt suffers a freak accident and needs care immediately. In a regime where contract remedies are

^{*} Section 356 of the Restatement (Second) of Contracts states that liquidated damages must be “reasonable in light of the anticipated or actual loss caused by the breach and the difficulties of proof of loss.” Eds.

exceedingly punitive, Holiday may choose not to break the contract with Armstrong. If she's the only brain surgeon in town, that choice may spell disaster for Reinhardt.

While the example is stylized and extreme, the principle is consistent with a dominant strain of analysis in contract law. As Justice Oliver Wendell Holmes, Jr., observed more than a century ago, contract law does not aim to prevent breach, just to order the payment of damages if the promisor chooses not to keep her promise. "The duty to keep a contract at common law means a prediction that you must pay damages if you do not keep it, – and nothing else." Oliver Wendell Holmes, Jr., *The Path of the Law*, 10 HARV. L. REV. 457, 462 (1897).

Some theorists posit this reluctance to order performance or grant punitive damages as evidence that the law recognizes some breach is efficient. In some cases, the breaching party will receive a greater benefit from engaging in new activity that it would from completing the contract, and the promisee who receives the benefit of its bargain – its expectancy in damages – should be indifferent to the change. Breach in those circumstances would be efficient, and the law should not discourage it. *See, e.g., Goetz & Scott, Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach*, 77 COLUM. L. REV. 554 (1977).

3. Why might parties agree to liquidated damages when they first enter a contract? Over time, if courts refuse to enforce liquidated damages provisions, can parties still get what they want from such a provision? Some companies pay "golden parachutes" to executives under clauses that most courts would find to be "penalty clauses." Why do you think these companies rarely challenge the clauses?
4. Consider the following hypothetical. In January, Parker pays a \$500 deposit for his son to attend Simone's summer camp. The contract specifies that if a refund is requested prior to February 1, the deposit will be refunded in full, less a \$25 administrative fee. No refund of the deposit will be issued if requested on or after February 1. The contract specifies that any retained deposit constitutes liquidated damages for cancellation. Parker finds out on March 1 that his son failed a class and must attend summer school. He cancels the contract and requests a refund of the deposit. Assume Parker is in breach. Should a court conclude the retention of the deposit is valid liquidation, or an unenforceable penalty? Is the damage of having a child cancel a slot for summer camp somehow difficult to accurately estimate in advance? Is the loss of the deposit a reasonable forecast of what is required to fairly compensate the camp? *See Pacheco v. Scoblionko*, 532 A.2d 1036 (Me. 1987).

5. *Lake River Corp.* may look like a sales-of-goods case but is in fact a service contract for bagging and distributing the goods in question. Thus the UCC did not govern the outcome. The next case interprets the UCC's provision on liquidated damages, § 2-718.

Michael E. Kvassay, d/b/a Kvassay Exotic Foods v. Albert Murray

15 Kan. App. 2d 426 (Court of Appeals of Kansas 1991)

RICHARD B. WALKER, District Judge.

Plaintiff Michael Kvassay, d/b/a Kvassay Exotic Food, appeals the trial court's finding that a liquidated damages clause was unenforceable and from the court's finding that damages for lost profits were not recoverable. Kvassay contends these damages occurred when Great American Foods, Inc., (Great American) breached a contract for the purchase of baklava. Great American and Albert and Deana Murray, principals of Great American, cross-appeal the trial court's ruling that Kvassay could pierce Great American's corporate veil to collect damages awarded at trial.

On February 22, 1984, Kvassay, who had been an independent insurance adjuster, contracted to sell 24,000 cases of baklava to Great American at \$19.00 per case. Under the contract, the sales were to occur over a one-year period and Great American was to be Kvassay's only customer. The contract included a clause which provided: "If Buyer refuses to accept or repudiates delivery of the goods sold to him, under this Agreement, Seller shall be entitled to damages, at the rate of \$5.00 per case, for each case remaining to be delivered under this Contract."

Problems arose early in this contractual relationship with checks issued by Great American being dishonored for insufficient funds. Frequently one of the Murrays issued a personal check for the amount due. After producing approximately 3,000 cases, Kvassay stopped producing the baklava because the Murrays refused to purchase any more of the product.

In April 1985, Kvassay filed suit for damages arising from the collapse of his baklava baking business. Great American counterclaimed and, in May 1988, the trial court sustained a defense motion to bifurcate the case.... The trial court ruled that liquidated damages could not be recovered ... The court also held "as a matter of law" that Kvassay would not be able to recover damages for lost profits in the action because they were too "speculative and conjectural." Kvassay attacked this latter ruling through a motion to modify, arguing a ruling on the issue

was premature. The motion to modify was denied, although the court did announce that Kvassay could attempt to prove loss of profits at the jury trial.*

A jury trial on the issues of breach of contract and damages was held in February 1990. On the second day of trial, before any evidence on the question of loss of profits had been presented, the trial court ruled that lost profits were not recoverable and barred Kvassay from presenting any evidence on that question. The jury returned verdicts in Kvassay's favor and awarded him a total of \$35,673.99.

Kvassay... attacks the trial court's ruling that the amount of liquidated damages sought by him was unreasonable and therefore the liquidated damages clause was unenforceable.

Kvassay claimed \$105,000 in losses under the liquidated damages clause of the contract, representing \$5 per case for the approximately 21,000 cases of baklava which he was not able to deliver. The trial court determined that Kvassay's use of expected profits to formulate liquidated damages was improper because the business enterprise lacked duration, permanency, and recognition. The court then compared Kvassay's previous yearly income (about \$20,000) with the claim for liquidated damages (\$105,000) and found "the disparity becomes so great as to make the clause unenforceable."

Liquidated damages clauses in sales contracts are governed by K.S.A. 84-2-718, which reads in part:

"(1) 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."

To date, the appellate courts have not interpreted this section of the UCC in light of facts similar to those presented in this case. In ruling on this issue, the trial court relied on rules governing liquidated damages as expressed in *U.S.D. No. 315 v. DeWerff*, 6 Kan.App.2d 77 (Kan. App. 1981). *DeWerff*, however, involved a teacher's breach of an employment contract

* Note that uncertainty about the promisee's business venture can lead to a court denying damage for lost profits.

and was not governed by the UCC. Thus, the rules expressed in that case should be given no effect if they differ from the rules expressed in 84-2-718.

In *DeWerff*, this court held a “stipulation for damages upon a future breach of contract is valid as a liquidated damages clause if the set amount is determined to be reasonable and the amount of damages is difficult to ascertain.” 6 Kan.App.2d at 78. This is clearly a two-step test: Damages must be reasonable and they must be difficult to ascertain. Under the UCC, however, reasonableness is the only test. K.S.A. 84-2-718. K.S.A. 84-2-718 provides three criteria by which to measure reasonableness of liquidated damages clauses: (1) anticipated or actual harm caused by breach; (2) difficulty of proving loss; and (3) difficulty of obtaining an adequate remedy.

In its ruling, the trial court found the liquidated damages clause was unreasonable in light of Kvassay’s income before he entered into the manufacturing contract with Great American. There is no basis in 84-2-718 for contrasting income under a previous unrelated employment arrangement with liquidated damages sought under a manufacturing contract. Indeed, the traditional goal of the law in cases where a buyer breaches a manufacturing contract is to place the seller “in the same position he would have occupied if the vendee had performed his contract.” *Outcault Adv. Co. v. Citizens Nat’l Bank*, 118 Kan. 328, 330-31 (Kan. 1925). Thus, liquidated damages under the contract in this case must be measured against the anticipated or actual loss under the baklava contract as required by 84-2-718. The trial court erred in using Kvassay’s previous income as a yardstick.

Was the trial court correct when it invalidated the liquidated damages clause, notwithstanding the use of an incorrect test? If so, we must uphold the decision even though the trial court relied on a wrong ground or assigned an erroneous reason for its decision. *Sutter Bros. Constr. Co. v. City of Leavenworth*, 238 Kan. 85, 93 (Kan. 1985). To answer this question, we must look closer at the first criteria for reasonableness under 84-2-718, anticipated or actual harm done by the breach.

Kvassay produced evidence of anticipated damages at the bench trial showing that, before the contract was signed between Kvassay and Great American, Kvassay’s accountant had calculated the baklava production costs. The resulting figure showed that, if each case sold for \$19, Kvassay would earn a net profit of \$3.55 per case after paying himself for time and labor. If he did not pay himself, the projected profit was \$4.29 per case. Nevertheless, the parties set the liquidated damages figure at \$5 per case. In comparing the anticipated damages of \$3.55 per case in lost net profit with the liquidated damages of \$5 per case, it is evident that Kvassay would collect \$1.45 per case or about 41 percent over projected profits if Great American

breached the contract. If the \$4.29 profit figure is used, a \$5 liquidated damages award would allow Kvassay to collect 71 cents per case or about 16 ½ percent over projected profits if Great American breached the contract.

An examination of these pre-contract comparisons alone might well lead to the conclusion that the \$5 liquidated damages clause is unreasonable because enforcing it would result in a windfall for Kvassay and serve as a penalty for Great American. A term fixing unreasonably large liquidated damages is void as a penalty under 84–2–718.

A better measure of the validity of the liquidated damages clause in this case would be obtained if the actual lost profits caused by the breach were compared to the \$5 per case amount set by the clause. However, no attempt was made by Kvassay during the bench trial to prove actual profits or actual costs of production. Thus, the trial court could not compare the \$5 liquidated damages clause in the contract with the actual profits lost by the breach. It was not until the jury trial that Kvassay attempted to prove his actual profits lost as part of his damages. Given the trial court's ruling that lost profits were not recoverable and could not be presented to the jury, it is questionable whether the court would have permitted evidence concerning lost profits at the bench trial.

The trial court utilized an impermissible factor to issue its ruling on the liquidated damages clause and the correct statutory factors were not directly addressed. We reverse the trial court on this issue and remand for further consideration of the reasonableness of the liquidated damages clause in light of the three criteria set out in 84–2–718 and our ruling on recoverability of lost profits which follows.

In ruling that Kvassay could not recover lost profits, the court held.... “[A]s a matter of law ... this bakery business was not in existence a sufficient length of time that the calculation of future profits is sufficiently reliable to be a basis for the recovery of damages.”

.... The specific section governing lost profits is K.S.A. 84–2–708, which states:

“(1) Subject to subsection (2) and to the provisions of this article with respect to proof of market price (section 84–2–723), the measure of damages for nonacceptance or repudiation by the buyer is the difference between the market price at the time and place for tender and the unpaid contract price together with any incidental damages provided in this article (section 84–2–710), but less expenses saved in consequence of the buyer's breach.

“(2) If the measure of damages provided in subsection (1) is inadequate to put the seller in as good a position as performance would have done then the measure of damages is the profit (including reasonable overhead) which the seller would have made from full performance by the buyer, together with any incidental damages provided in this article (section 84–2–710), due allowance for costs reasonably incurred and due credit for payments or proceeds of resale.”

A plain reading of this statute leads to the conclusion that section (2) applies in this case because there was no market for Kvassay’s baklava after Great American breached the contract....

The official UCC comment to 84–2–708 states: “It is not necessary to a recovery of ‘profit’ to show a history of earnings, especially if a new venture is involved.” By this standard, Kvassay did not need to prove a record of profitability to claim lost profits under the UCC and the trial court erred in so ruling.

The closely related final question is whether the trial court erred in ruling “as a matter of law ... this bakery business was not in existence a sufficient length of time that the calculation of future profits is sufficiently reliable to be a basis for the recovery of damages.” The role of the courts in determining the acceptability of proof of lost profits for new businesses has been discussed in Kansas. *[citations omitted]* Although none of these cases discusses lost profits for new businesses in light of the UCC, they are instructive. *Vickers [v. Wichita State University]*, 518 P.2d 512, contains this comment:

“Unquestionably, a method of establishing a loss of profits with reasonable certainty is by showing a history of past profitability. Past profitability of a particular business is not, however, the only method of proving lost future profits. The evidence necessary in establishing lost future profits with reasonable certainty ‘must depend in a large measure upon the circumstances of the particular case....’ [Citation omitted.] Absolute certainty in proving loss of future profits is not required. [Citation omitted.] What is required is that the court or jury be guided by some rational standard. [Citations omitted.] As to evidentiary matters a court should approach each case in an individual and pragmatic manner, and require the claimant furnish the best available proof as to the amount of loss that the particular situation admits. [Citation omitted.] It

is the responsibility of a district court to see that speculative and problematical evidence does not reach the jury. [Citation omitted.]”

There is no reason the standard should be any different under the UCC section which specifically allows lost profits as damages (84–2–708) and which requires that remedies under the act be “liberally administered to the end that the aggrieved party may be put in as good a position as if the other party had fully performed.” K.S.A. 84–1–106.*

Lost profits may be recovered for new businesses if they can be proved with reasonable certainty. *Butler [v. Westgate State Bank]*, 226 Kan. at 585, 602 P.2d 1276. Strict application of the certainty doctrine would place a new business at substantial disadvantage. To hold recovery is precluded as a matter of law merely because a business is newly established would encourage those contracting with such a business to breach their contracts. The law is not so deficient. *Vickers*, 518 P.2d 512. When 84–1–106 and 84–2–708(2) are read in light of *Vickers*, it is clear that, when there has been a breach of contract with a new business, such business should be given an opportunity to prove its damages and to collect profits if the damages can be proved.

In this case, Kvassay attempted to present an ample basis on which to determine profits earned on the baklava produced under the contract. Uncontested evidence offered included:

1. Kvassay did not go into the bakery business until he had a contract with Great American requiring the purchase of 24,000 cases of baklava at \$19 per case.
2. After spending about two months setting up his bakery, Kvassay produced baklava full time for about three months, although there were some temporary shut-downs due to cash flow problems.
3. Production was averaging about 100 cases daily, although a peak of 150 cases was reached.
4. 3,000 cases of the 24,000 contracted for were produced, or 12.5 percent of the contract.
5. Production staff was paid on a commission basis based on the number of trays of baklava prepared at a rate of \$1.75–\$2.00 per tray.

* The text of the former UCC § 1-106 was adopted as K.S.A. § 84-1-106. Now, that language is found in UCC § 1-305 and K.S.A. § 84-1-305. Eds.

6. The recipe for each 14-inch x 18-inch tray of baklava called for two pounds of phyllo dough, one pound of margarine, one teaspoon of cloves, one teaspoon of cinnamon, one pound of walnuts, and two pounds of honey.
7. Each tray produced ten 8-ounce pieces of baklava while each case delivered held twelve 8-ounce pieces of baklava.
8. There were two full-time hourly employees and additional help was hired on an hourly basis for maintenance when needed.

In addition, before the court ruled that lost profits could not be proved, Kvassay attempted to offer receipts from suppliers to document his costs. The trial court never permitted those exhibits to be admitted. Further, after the court ruled that lost profits would not be allowed, Kvassay proffered the testimony of two accountants as to the profitability of his enterprise and the profit he would have earned under the contract with Great American. Of particular note was the testimony of Tom Dechant, C.P.A., who testified that, from an accounting standpoint, at least 5 percent of the baklava contract needed to be completed before profits could be determined with “reasonable certainty.” In this case, 12.5 percent of the contract had been completed.

Given the quantity of evidence offered to prove the profitability of Kvassay’s business, it is clear the trial court was premature in ruling, as a matter of law, that lost profits could not be proved. Kvassay should have been permitted to offer his evidence and meet his burden of proof on damages.

The trial court’s decisions with respect to liquidated damages and lost profits are reversed and the case is remanded for a new trial on those issues.

Notes and Questions

1. Section 2-718(2) was discussed in *Neri v. Retail Marine*. Section 2-718(2) provides a default liquidated damages provision if parties do not contract for one. The provision sets the amount that the buyer’s deposit can be retained by the seller in case of breach, ordering restitution of anything above \$500 or 20% of the buyer’s obligation, whichever is smaller. Note that an amount above the minimum may be retained if the seller establishes damages under any other provision under Article 2, or benefits received by the buyer. UCC § 2-718(3).

2. Why is the UCC's version of liquidated damages law contained within the same provision that deals with deposits, the focus of *Neri*? Is the UCC standard for liquidated damages different from the common law's in Illinois, discussed in *Lake River*?
3. Some liquidated damages provisions fail when the contract ostensibly liquidates several different harms with a single liquidated damages amount. Such a clause is called "undifferentiated" and unenforceable as a penalty. See, e.g., *Wilt v. Waterfield*, 273 S.W.2d 290 (Mo. 1954). Can you guess why courts find undifferentiated clauses unenforceable?
4. Rollins contracts with Strayhorn County to build a bridge connecting the city of Chelsea to a new road being built on the other side of a river. The contract liquidates damages for late completion of the bridge at \$100 per day. Rollins is 30 days late, but when the bridge is complete, the road on the other side of the river is still incomplete and not open to through traffic. Rollins concedes the breach but argues that the county was not damaged by the delay, and thus should receive no liquidated damages. What result? See *Massman Constr. Co. v. City Council of Greenville*, Miss., 147 F.2d 925 (5th Cir. 1945).
5. Would a liquidated damages provision penalize the promisee if the liquidated amount is too low? Consider the following: Horne signs up for Hampton Security Services, which promises to monitor Horne's home for break-ins and call police in the case of an event. Horne's home suffers a break-in, but due to negligence on the part of Hampton and its employees, the police are never called. Horne argues the failure caused a loss of \$10,000 in stolen property. Hampton concedes the breach but argues that the contract liquidates damages at \$50. What result? See *Samson Sales, Inc. v. Honeywell, Inc.*, 12 Ohio St. 3d 27 (Ohio 1984).
 - a. If the court allows Horne to establish damages, how does that effect the business model of Hampton and firms like it?
 - b. Do you suspect Horne was able to negotiate with Hampton over the liquidated damages clause, or do you think she was required to accept the clause as written if she wanted to do business with them?

Zapata Hermanos Sucesores, S.A. v. Hearthside Baking Co., Inc.

313 F.3d 385 (7th Cir. 2002)

POSNER, Circuit Judge.

Zapata, a Mexican corporation that supplied Lenell, a U.S. wholesale baker of cookies, with cookie tins, sued Lenell for breach of contract and won. The district judge ordered Lenell to pay Zapata \$550,000 in attorneys' fees. From that order, which the judge based both on a provision of the Convention on Contracts for the International Sale of Goods, Jan. 1, 1988, 15 U.S.C. App., and on the inherent authority of the courts to punish the conduct of litigation in bad faith, Lenell appeals.

The Convention, of which both the U.S. and Mexico are signatories, provides, as its name indicates, remedies for breach of international contracts for the sale of goods. Zapata brought suit under the Convention for money due under 110 invoices, amounting to some \$900,000 (we round liberally), and also sought prejudgment interest plus attorneys' fees, which it contended are "losses" within the meaning of the Convention and are therefore an automatic entitlement of a plaintiff who prevails in a suit under the Convention. At the close of the evidence in a one-week trial, the judge granted judgment as a matter of law for Zapata on 93 of the 110 invoices, totaling \$850,000. Zapata's claim for money due under the remaining invoices was submitted to the jury, which found in favor of Lenell. Lenell had filed several counterclaims; the judge dismissed some of them and the jury ruled for Zapata on the others. The jury also awarded Zapata \$350,000 in prejudgment interest with respect to the 93 invoices as to which Zapata had prevailed, and the judge then tacked on the attorneys' fees – the entire attorneys' fees that Zapata had incurred during the litigation.

Article 74 of the Convention provides that "damages for breach of contract by one party consist of a sum equal to the loss, including loss of profit, suffered by the other party as a consequence of the breach," provided the consequence was foreseeable at the time the contract was made. Article 7(2) provides that "questions concerning matters governed by this Convention which are not expressly settled in it are to be settled in conformity with the general principles on which it is based or, in the absence of such principles, in conformity with the law applicable by virtue of the rules of private international law [i.e., conflicts of law rules]." There is no suggestion in the background of the Convention or the cases under it that "loss" was intended to include attorneys' fees, but no suggestion to the contrary either. Nevertheless it seems apparent that "loss" does not include attorneys' fees incurred in the litigation of a suit for breach of contract, though certain prelitigation legal expenditures, for example expenditures designed to mitigate the plaintiff's damages, would probably be covered as "incidental" damages. *Sorenson v. Fio Rito*, 413 N.E.2d 47, 50–52 (Ill. App. 1980); cf. *Tull v.*

Gundersons, Inc., 709 P.2d 940, 946 (Colo. 1985); Restatement (Second) of Contracts § 347, Comment c (1981).

The Convention is about contracts, not about procedure. The principles for determining when a losing party must reimburse the winner for the latter's expense of litigation are usually not a part of a substantive body of law, such as contract law, but a part of procedural law. For example, the "American rule," that the winner must bear his own litigation expenses, and the "English rule" (followed in most other countries as well), that he is entitled to reimbursement, are rules of general applicability. They are not field-specific. There are, it is true, numerous exceptions to the principle that provisions regarding attorneys' fees are part of general procedure law....But not only is the question of attorneys' fees not "expressly settled" in the Convention, it is not even mentioned. And there are no "principles" that can be drawn out of the provisions of the Convention for determining whether "loss" includes attorneys' fees; so by the terms of the Convention itself the matter must be left to domestic law (i.e., the law picked out by "the rules of private international law," which means the rules governing choice of law in international legal disputes).

The interpretation of "loss" for which Zapata contends would produce anomalies; this is another reason to reject the interpretation. On Zapata's view the prevailing plaintiff in a suit under the Convention would (though presumably subject to the general contract duty to mitigate damages, to which we referred earlier) get his attorneys' fees reimbursed more or less automatically (the reason for the "more or less" qualification will become evident in a moment). But what if the defendant won? Could he invoke the domestic law, if as is likely other than in the United States that law entitled either side that wins to reimbursement of his fees by the loser? Well, if so, could a winning plaintiff waive his right to attorneys' fees under the Convention in favor of domestic law, which might be more or less generous than Article 74, since Article 74 requires that any loss must, to be recoverable, be foreseeable, which beyond some level attorneys' fees, though reasonable ex post, might not be? And how likely is it that the United States would have signed the Convention had it thought that in doing so it was abandoning the hallowed American rule? To the vast majority of the signatories of the Convention, being nations in which loser pays is the rule anyway, the question whether "loss" includes attorneys' fees would have held little interest; there is no reason to suppose they thought about the question at all.

For these reasons, we conclude that "loss" in Article 74 does not include attorneys' fees, and we move on to the question of a district court's inherent authority to punish a litigant or the

litigant's lawyers for litigating in bad faith. The district judge made clear that he was basing his award of attorneys' fees to Zapata in part on his indignation at Lenell's having failed to pay money conceded to be owed to Zapata. Although the precise amount was in dispute, Lenell concedes that it owed Zapata at least half of the \$1.2 million that Zapata obtained in damages (not counting the attorneys' fees) and prejudgment interest. Lenell had no excuse for not paying that amount, and this upset the judge.

Firms should pay their debts when they have no legal defense to them. *Pacta sunt servanda*, as the saying goes ("contracts are to be obeyed"). In the civil law (that is, the legal regime of Continental Europe), this principle is taken very seriously, as illustrated by the fact that the civil law grants specific performance in breach of contract cases as a matter of course. But under the common law (including the common law of Illinois, which is the law that choice of law principles make applicable to any issues in this case not covered in express terms by the Convention), a breach of contract is not considered wrongful activity in the sense that a tort or a crime is wrongful. When we delve for reasons, we encounter Holmes's argument that practically speaking the duty created by a contract is just to perform or pay damages, for only if damages are inadequate relief in the particular circumstances of the case will specific performance be ordered. In other words, and subject to the qualification just mentioned, the entire practical effect of signing a contract is that by doing so one obtains an option to break it. The damages one must pay for breaking the contract are simply the price if the option is exercised. See Oliver Wendell Holmes, Jr., *The Common Law* 300–02 (1881); Holmes, "The Path of the Law," 10 HARV. L. REV. 457, 462 (1897).

Why such lenity? Perhaps because breach of contract is a form of strict liability. Many breaches are involuntary and so inapt occasions for punishment. Even deliberate breaches are not necessarily culpable, as they may enable an improvement in efficiency – suppose Lenell had a contract to take a certain quantity of tins from Zapata and found that it could buy them for half the price from someone else. Some breaches of contract, it is true, are not only deliberate but culpable, and maybe this was one – Lenell offers no excuse for failing to pay for tins that it had taken delivery of and presumably resold with its cookies in them. Refusing to pay the contract price after the other party has performed is not the kind of option that the performing party would willingly have granted when the contract was negotiated. The option of which Holmes spoke was the option not to perform because performance was impossible or because some more valuable use of the resources required for performance arose after the contract was signed. Zapata argues, moreover, perhaps correctly (we need not decide), that Lenell refused to pay in an effort to extract a favorable modification of the terms of the parties' dealings, which would be a form of duress if Zapata somehow lacked an effective legal remedy.

Professional Service Network, Inc. v. American Alliance Holding Co., 238 F.3d 897, 900–01 (7th Cir. 2001); *Alaska Packers' Ass'n v. Domenico*, 117 F. 99, 100–04 (9th Cir. 1902). But Zapata did not charge duress, and probably couldn't, since it had a good remedy – this suit.

It is true that nowadays common law courts will sometimes award punitive damages for breach of contract in bad faith. But outside the field of insurance, where refusals in bad faith to indemnify or defend have long been punishable by awards of punitive damages to the insured, the plaintiff must show that the breach of contract involved tortious misconduct, such as duress or fraud or abuse of fiduciary duty. See, e.g., *Miller Brewing Co. v. Best Beers of Bloomington, Inc.*, 608 N.E.2d 975, 982–83 (Ind. 1993); *Story v. City of Bozeman*, 791 P.2d 767, 776 (Mont. 1990); E. Allan Farnsworth, *Contracts* § 12.8, pp. 788–89 (3d ed. 1999). This is the rule in Illinois, *Morrow v. L.A. Goldschmidt Associates, Inc.*, 112 Ill.2d 87, 96 Ill.Dec. 939, 492 N.E.2d 181, 183–86 (Ill. 1986), and Zapata has not tried to come within it. For that matter, it did not ask for punitive damages, and the judge had no authority to award attorneys' fees in lieu of such damages. He could not have awarded punitive damages if Zapata had asked for them but had been unable to prove tortious misconduct by Lenell, and even more clearly he could not award them when they had not been requested.

The inherent authority of federal courts to punish misconduct before them is not a grant of authority to do good, rectify shortcomings of the common law (as by using an award of attorneys' fees to make up for an absence that the judge may deem regrettable of punitive damages for certain breaches of contract), or undermine the American rule on the award of attorneys' fees to the prevailing party in the absence of statute.

AFFIRMED IN PART, REVERSED IN PART, AND REMANDED.

Notes and Questions

1. The CISG is the United Nations Convention on Contracts for the International Sale of Goods. Much as the UCC is the de facto law of the land covering sales of goods in U.S. cases (excluding Louisiana), the CISG is a treaty that governs the sales of goods for parties from different signatory nations. The U.S., Mexico, and Canada are among the signatories. The United Kingdom and India are notable non-signees. Parties from non-signee nations can opt to use the CISG's provisions via contract. And the CISG

is a set of default rules that parties from signatory nations can contract around. Like the UCC, the CISG doesn't cover service contracts or contracts for sale of real property. Unlike the UCC, the CISG doesn't cover online sales of goods to consumers.

2. Costs of litigation, including attorneys' fees, can be handled in one of two ways. The American system is predominantly a "winner pays" system, where each litigant covers its own costs of litigation. There are exceptions, but the general perception is that the prevailing party in a contract dispute is *not* entitled to attorneys' fees from the losing party.
3. This is not the only way a legal system could be structured. Most jurisdictions follow what U.S. courts call the "English" rule. In those systems, the loser pays the costs of the prevailing party, including attorneys' fees.
4. One potential difficulty with the winner pays regime is that the prevailing party, arguably entitled to the benefit of its bargain, must incur sometimes significant costs to secure the recovery that ostensibly makes it whole. As one court stated it, "efficient breach is rarely efficient; the winning party must pay the cost of recovering contract damages." *Story v. City of Bozeman*, 242 Mont. 436, 448 (Mont. 1990). Thus, if a prevailing party in a contract dispute receives an award of \$100,000 in damages, but attorneys' fees cost \$33,000, a winner pays system leaves the promisee spending roughly 1/3 of her recovery on attorneys' fees. See David G. Owen, *A Punitive Damages Overview: Functions, Problems and Reform*, 39 VILL. L. REV. 363, 379 (1994) ("[A]t least one-third of the plaintiff's recovery ordinarily is expended on legal fees").
5. There are exceptions to the general rule in contracts cases. See DAN B. DOBBS & CAPRICE L. ROBERTS, *LAW OF REMEDIES: DAMAGES, EQUITY, RESTITUTION* § 3.10(3) (3d ed. 2018). For example, the parties can stipulate by contract that a party who successfully pursues its case in court is entitled to attorneys' fees. See, e.g., *Equitable Lumber Corp. v. IPA Land Dev. Corp.*, 344 N.E.2d 391 (N.Y. 1976). States can designate a loser pays rule by statute. For example, Arkansas has a provision that provides attorneys' fees in certain civil actions, including contract disputes relating to sales of goods, labor, or services. Ark. Code 16-22-308. Florida has a reciprocity provision that mandates if one party is guaranteed attorneys' fees by contract, the court can apply statutory law and allow the other party the same right. Fla. Stat. § 57.105(7). See also *Inland Dredging Co. v. The Panama City Port Authority*, 406 F. Supp. 2d 1277 (N.D. Fla. 2005).

6. Judge Posner connects punitive damages, which are rarely if ever awarded in contracts cases, with attorneys' fees. Similarly, the Court of Appeals in New York turned to § 2-718 in a sales-of-goods case to assess whether a provision specifying attorneys' fees was so high as to amount to a penalty. *Equitable Lumber Corp. v. IPA Land Dev. Corp.*, 38 N.Y.2d 516, 523–24 (N.Y. 1976). In related fashion, courts in Connecticut and Michigan justify punitive damages in some cases as a proxy for otherwise unobtainable attorney's fees. *Triangle Sheet Metal Works, Inc. v. Silver*, 154 Conn. 116, 127 (Conn. 1966); *Peisner v. Detroit Free Press*, 68 Mich. App. 360, 371 (Mich. App. 1976).