

**Lake River Corporation, Plaintiff-Appellee-Cross-Appellant,
V.
Carborundum Company, Defendant-Appellant-Cross-Appellee**

United States Court of Appeals for The Seventh Circuit
769 F.2d 1284 (1985)

[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 facility. In order to ensure that it would cover the cost of the bagging facility Lake River insisted on a minimum quantity guarantee. If during the term of the contract less was shipped than guaranteed, Lake River would charge Carborundum the difference between the actual amount shipped and the amount guaranteed.

Carborundum failed to ship the guaranteed amount. Lake River demanded payment for the guaranteed amount. Carborundum refused arguing that the clause in the contract imposed a penalty. In response, Lake River refused to release the Ferro Carbo that was in its warehouse unless Carborundum agreed to pay the guaranteed amount.

Lake River brought suit for liquidated damages. Carborundum sued for return of the Ferro Carbo and incidental damages. Is a minimum guarantee clause a penalty clause?]

JUDGES: Eschbach and Posner, Circuit Judges, and Gibson, Senior Circuit Judge. *

* Hon. Floyd R. Gibson of the Eighth Circuit, sitting by designation.

OPINIONBY: POSNER

...

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 theory of the counterclaim is that the impounding was a conversion, and not as Lake River contends the assertion of a lien. The district judge, after a bench trial, gave judgment for both parties. Carborundum ended up roughly \$42,000 to the good: \$269,000 + \$31,000-\$24100-\$17,000, the last figure representing prejudgment interest on Lake River's damages. (We have rounded off all dollar figures to the nearest thousand.) Both parties have appealed.

The only issue that is not one of damages is whether Lake River had a valid lien on the bagged Ferro Carbo that it refused to ship to Carborundum's customers -- that, indeed, it holds in its warehouse to this day. Although Ferro Carbo does not deteriorate with age, the domestic steel industry remains in the doldrums and the product is worth less than it

was in 1982 when Lake River first withheld it. If Lake River did not have a valid lien on the product, then it converted it, and must pay Carborundum the \$269,000 that the Ferro Carbo was worth back then.

It might seem that if the minimum-guarantee clause was a penalty clause and hence unenforceable, the lien could not be valid, and therefore that we should discuss the penalty issue first. But this is not correct. If the contractual specification of damages is invalid, Lake River still is entitled to any actual damages caused by Carborundum's breach of contract in failing to deliver the minimum amount of Ferro Carbo called for by the contract. The issue is whether an entitlement to damages, large or small, entitles the victim of the breach to assert a lien on goods that are in its possession though they belong to the other party.

[The court examines whether Lake River had a valid lien on the Ferro Carbo it was holding and decides that it did not.]

...

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. Deep as the hostility to penalty clauses runs in the common law... we still might be inclined to question, if we thought ourselves free to do so, whether a modern court should refuse to enforce a penalty clause where the signator is a substantial corporation, well able to avoid improvident commitments. Penalty clauses provide an earnest of performance. 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. On the other side it can be pointed out that by raising the cost of a breach of contract to the contract breaker, a penalty clause increases the risk to his other creditors; increases (what is the same thing and more, because bankruptcy imposes "deadweight" social costs) the risk of bankruptcy; and could amplify the business cycle by increasing the number of bankruptcies in bad times, which is when contracts are most likely to be broken. But since little effort is made to prevent businessmen from assuming risks, these reasons are no better than makeweights.

A better argument is that a penalty clause may discourage efficient as well as inefficient breaches of contract. Suppose a breach would cost the promisee \$12,000 in actual damages but would yield the promisor \$20,000 in additional profits. Then there would be a net social gain from breach. After being fully compensated for his loss the promisor would be no worse off than if the contract had been performed, while the promisee would be better off by \$8,000. But now suppose the contract contains a penalty clause under which the promisor if he breaks his promise must pay the promisee \$25,000. The promisor will be discouraged from breaking the contract, since \$25,000, the penalty, is greater than \$20,000, the profits of the breach; and a transaction that would have increased value will be forgone.

On this view, since 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. ...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. ...

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. ... 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.

Lake River argues that it would never get as much as the formula suggests, because it would be required to mitigate its damages. This is a dubious argument on several

grounds. First, mitigation of damages is a doctrine of the law of court-assessed damages, while the point of a liquidated-damages clause is to substitute party assessment; and that point is blunted, and the certainty that liquidated-damages clauses are designed to give the process of assessing damages impaired, if a defendant can force the plaintiff to take less than the damages specified in the clause, on the ground that the plaintiff could have avoided some of them. It would seem therefore that the clause in this case should be read to eliminate any duty of mitigation, that what Lake River is doing is attempting to rewrite the clause to make it more reasonable, and that since actually the clause is designed to give Lake River the full damages it would incur from breach (and more) even if it made no effort to find a substitute use for the equipment that it bought to perform the contract, this is just one more piece of evidence that it is a penalty clause rather than a liquidated-damages clause. ...

But in any event mitigation would not mitigate the penal character of this clause. If Carborundum did not ship the guaranteed minimum quantity, the reason was likely to be -- the reason was -- that the steel industry had fallen on hard times and the demand for Ferro Carbo was therefore down. In these circumstances Lake River would have little prospect of finding a substitute contract that would yield it significant profits to set off against the full contract price, which is the method by which it proposes to take account of mitigation. At argument Lake River suggested that it might at least have been able to sell the new bagging equipment to someone for something, and the figure \$40,000 was proposed. If the breach occurred on the first day when performance under the contract was due and Lake River promptly sold the bagging equipment for \$40,000, its liquidated damages would fall to \$493,000. But by the same token its costs would fall to \$49,000. Its profit would still be \$444,000, which as we said was more than 400 percent of its expected profit on the contract. The penal component would be unaffected.

...

We do not mean by this discussion to cast a cloud of doubt over the "take or pay" clauses that are a common feature of contracts between natural gas pipeline companies and their customers. Such clauses require the customer, in consideration of the pipeline's extending its line to his premises, to take a certain amount of gas at a specified price -- and if he fails to take it to pay the full price anyway. The resemblance to the minimum-guarantee clause in the present case is obvious, but perhaps quite superficial. Neither party has mentioned take-or-pay clauses, and we can find no case where such a clause was even challenged as a penalty clause -- though in one case it was argued that such a clause made the damages unreasonably *low*. ... If, as appears not to be the case here but would often be the case in supplying natural gas, a supplier's fixed costs were a very large fraction of his total costs, a take-or-pay clause might well be a reasonable liquidation of damages. In the limit, if *all* the supplier's costs were incurred before he began supplying the customer, the contract revenues would be an excellent measure of the damages from breach. But in this case, the supplier (Lake River, viewed as a supplier of bagging services to Carborundum) incurred only a fraction of its costs before performance began, and the interruption of performance generated a considerable cost saving that is not reflected] in the damage formula.

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. ... 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.

Two damage issues remain. The first concerns Carborundum's expenses of delivering bagged Ferro Carbo to its customers to replace that impounded by Lake River. The district judge gave Carborundum the full market value of the bagged Ferro Carbo. Lake River argues that it should not have to pay for Carborundum's expense of selling additional Ferro Carbo -- additional in the sense that Carborundum is being given credit for the full retail value of the product that Lake River withheld. To explain, suppose that Carborundum had an order for \$1,000 worth of bagged Ferro Carbo, which Lake River was supposed to deliver; and because it refused, Carborundum incurred a transportation cost of \$100 to make a substitute shipment of bagged Ferro Carbo to the customer. Carborundum would still get \$1,000 from the customer, and if that price covered the transportation cost it would still make a profit. In what sense, therefore, is that cost a separate item of damage, of loss? On all Ferro Carbo (related to this case) sold by Carborundum in the Midwest, Carborundum received the full market price, either from its customers in the case of Ferro Carbo actually delivered to them, or from Lake River in the case of the Ferro Carbo that Lake River refused to deliver. Having received a price designed to cover all expenses of sale, a seller cannot also get an additional damage award for any of those expenses.

If, however, the additional Ferro Carbo that Carborundum delivered to its midwestern customers in substitution for Ferro Carbo previously delivered to, and impounded by, Lake River would have been sold in the East at the same price but lower cost, Carborundum would have had an additional loss, in the form of reduced profits, for which it could recover additional damages. But it made no effort to prove such a loss. Maybe it had no unsatisfied eastern customers, and expanded rather than shifted output to fulfill its midwestern customers' demand. The damages on the counterclaim must be refigured also.

Finally, Lake River argues that Carborundum failed to mitigate its damages by accepting Lake River's offer to deliver the bagged product and place the proceeds in escrow. But a converter is not entitled to retain the proceeds of the conversion even temporarily. Lake River had an opportunity to limit its exposure by selling the bagged product on Carborundum's account and deducting what it claimed was due it on its "lien." Its failure to follow this course reinforces our conclusion that the assertion of the lien was a naked attempt to hold Carborundum hostage to Lake River's view -- an erroneous view, as it has turned out -- of the enforceability of the damage formula in the contract.

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. ...

* * *

Questions

1. Judge Posner provides the following example to indicate that a penalty clause might deter an efficient breach of contracts

A better argument is that a penalty clause may discourage efficient as well as inefficient breaches of contract. Suppose a breach would cost the promisee \$12,000 in actual damages but would yield the promisor \$20,000 in additional profits. Then there would be a net social gain from breach. After being fully compensated for his loss the promisor would be no worse off than if the contract had been performed, while the promisee would be better off by \$8,000. But now suppose the contract contains a penalty clause under which the promisor if he breaks his promise must pay the promisee \$25,000. The promisor will be discouraged from breaking the contract, since \$25,000, the penalty, is greater than \$20,000, the profits of the breach; and a transaction that would have increased value will be forgone.

Given these circumstances, explain how the parties might renegotiate the contract to their mutual advantage. Are there circumstances under which a penalty clause might be efficient?

2. What is Judge Posner's primary reason for finding that the damage formula functions as a penalty clause? Do you agree with this analysis? Aren't the liquidated damages positively related to the unamortized cost of the bagging machinery?
3. How does the clause in question differ from the "take or pay" clause mentioned in the decision? Do you accept Posner's argument on the nature of the difference? Why or why not?
4. Do you agree with the court's reasoning for rejecting Carborundum's counter claim for increased delivery costs.