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Penalties and Liquidated Damages with Special Reference to the Law in New York

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T H E S I S

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It is almost impossible to formulate a single criterion to determine the question of a penalty or liquidated damages in every case; yet there has been certain rules established by decisions, which may be applied to different forms of arguments, yet there are of course many instances which can not be brought within their operation.

If the contract is for a matter of certain value and a certain amount is to be paid in breach of it which is in the excess of that amount, then and in that case the sum which is so fixed is to be regarded as a penalty and not as liquidated damages. While on the other hand, if the contract is for a matter of uncertain value and an amount is fixed to be paid in breach of the same, the sum is recovered as liquidated damages.

There are some rules which have been established by judicial authority which will now be taken up and fully discussed in every particular.

FIRST. When the payment of a smaller amount of money is secured by a larger amount, the amount then contracted for can under no circumstance whatever be treated as liquidated damages, but must in every case always be treated as a penalty. Pomeroy's Eq. Jur., Vol. I., Sec. 441. It is competent for all parties to a contract for the purchase or sale of real property to liquidate and settle by agreement among themselves the amount of damages which one party is to pay to the other upon a breach of the contract, instead of leaving such amount to be ascertained by a court or jury. Since injuries resulting from a breach are uncertain in amount, as they are in every case other than when the contract is to pay, the parties usually have the right to say how much shall be paid by way of compensation to the injured; and when they have settled that amount, neither a court of equity or a court of law will diminish its amount unless it be so in excess of the actual injury that a fair minded man would start at the bare mention of it. The courts are not authorized to make a

new contract for the parties, or unmake the one made by them, and hold, from the circumstances of the situation and the nature of the transaction, that the parties to the transaction intended anything different from what they expressed. When the parties to a contract, in which the amount of damages is to be ascertained, coming from a breach of a contract, is uncertain in amount, agree that a certain amount shall be the damages in case of failure to perform the same, and in language plainly expressive of an agreement I know of no principle or sound rule of law applicable to the construction of contracts which will enable a court of law to say that they intended something else. Where the sum fixed is greatly disproportionate to the presumed actual damage, probably a court of equity may relieve; but a court of law has no right to erroneously construe the intention of the parties to a contract, when it is clearly expressed, in the endeavor to make a better contract for them than they have actually made for themselves. In all cases, however, it is the duty of the courts to find out what the true intent of the parties is and then to carry it into effect. It is true that a cause may arise in which it is doubtful from the language

which is employed in the original instrument, whether the parties to the contract meant to agree upon the measure of compensation to the injured party in case of a breach. In such cases there would be room for construction; but certainly none when the meaning of the parties was evident and unmistakable. When they declare, in distinct and unequivocal terms, that they have settled and fixed the damages to be a certain amount, or any other sum to be paid by either failing to perform it seems wrong for a court to tell them that they have looked into the contract and reached the conclusion that it was not the thing which was intended; but that the intention was to name the sum as a penalty to cover any damages that might be proved to have been sustained by a breach of the agreement.

Certain rules have been established that are supposed to control the construction of contracts although in the view of some it has been difficult, if not impossible, to support an agreement for liquidated damages in cases where the amount ascertained by the parties seem disproportionate to the conjectured actual damages.

Where such damages as are stipulated in the gross

amount fixed by the terms of the contract for failure to perform the same, is in the nature of a penalty, or must be adjudged as liquidated damages, can only be determined by ascertaining the intention of the parties, as gathered both from the language of the contract and from the nature and circumstances of the case. Unless the intent of the parties is very clearly expressed the forfeiture named for non-fulfillment of a contract, when excessive, will not be construed as intended to be liquidated damages. Colnell vs. Lawrence et al, 38 N.Y., 71.

Where a sum is specifically named in a written agreement "as liquidated damages," in case either party should fail to perform the contract must, nevertheless, be construed as a penalty, when, upon the face of the instrument, it appears that such sum will necessarily be an inadequate compensation for the breach of some of the provisions and more than enough for the breach of others. This proposition is sustained by numerous authorities not only in New York but in other states.

Thus we see in Bagley vs. Peddu, 16 N.Y., 469, where a bond declared the obligors to be bound "in the sum of

$3000 as liquidated damages, and not by way of penalty or otherwise," for the performance of the covenants in a written agreement. None of the covenants was for the payment of money, or for the doing or omitting of any act the damages resulting from which could be computed from data furnished by the instrument itself; but the damages for any breach were uncertain and required evidence aliundi the instrument to establish their amount. One of the covenants was not to reveal the secrets of trade in which the principal obligor was to be employed, or any invention or improvement that might be made by his employment, the obligee. HELD, that a breach of this covenant involved damages so uncertain and difficult to be ascertained, as that the sum named should be deemed not a penalty but liquidated damages, recoverable upon a breach of any of the covenants, although the damages from the actual breach might be readily determined by a jury.

When it is doubtful whether the sum inserted was intended as a penalty or as liquidated damages, it will be considered in the nature of a penalty, especially if the payment of a certain damage less than the whole sum is provided for by the instrument; but where the sum applies as well to

stipulations where the damages, in case of breach necessarily must be uncertain, as to stipulations where the damages would be certain, it will be regarded as liquidated damages and not as a penalty.

SECOND. When the agreement is for the performance or non-performance of only one act, and there is no adequate mea means of ascertaining the precise damages which may result from a violation, the parties may, if they please, by a separate clause of the contract, fix upon the amount of compensation payable by the defaulting party in case of a breach and a stipulation inserted for such purpose will be treated a as one for "liquidated damages," unless the intent be clear that it was designed to be only a penalty. Pomeroy's Eq. Jur., Vol. I., Sec. 442.

There are various legal rules for ascertaining whether a sum named in a contract, to be paid by a defaulting party, was intended as liquidated damages or a penalty merely. Among these rules is one well established by numerous decisions, that when a contract is such that the damages, in case of a violation of it, will be uncertain in their na-

ture and amount, and the parties have stipulated that in the event of a breach a certain sum shall be paid by the party in default, as liquidated damages, they will be regarded as having so intended and that sum will be treated as the measure of damages.

In the case of Smith et al vs. Coe, 33 N.Y.Sup.Ct., 481. In an action brought upon an alleged breach of a covenant in a sealed lease, wherein the defendant covenanted that he would not at any time before June 1861, negotiate for, or accept, or be interested in any lease of certain premises except from the plaintiff, under a forfeiture of ten thousand dollars, to be paid liquidated damages and not as a penalty,- HELD, that the only question for the jury to decide was as to a breach of the covenant, as set forth in the lease, and if they found that the defendant had violated the covenant then they must also find a verdict for damages of ten thousand dollars in favor of plaintiff according to the stipulation in the covenant.

THIRD. Where the agreement contains provisions for the performance or non-performance of acts which are not measur-

able by any exact pecuniary standard, and also of one or more other acts in respect of which the damages are easily ascertainable by a jury, and a certain sum is stipulated to be paid upon a violation of any or all of these provisions, such sum must be taken to be a penalty. Pomeroy's Eq.Jur., Vol. I., Sec. 445.

Where a party agrees to do several things, one of which is to pay a certain sum of money, and in case of a failure to perform any or either of the stipulations, agrees to pay a larger sum as liquidated damages, the larger sum is to be regarded in the nature of a penalty and being a penalty in regard to one of the stipulations to be performed, is a penalty as to all."To the same effect are the case:- Clement vs. Cash, 21 N.Y., 253, 259; Bagley vs. Peddei, 16 N.Y., 410.

FOURTH. This rule plainly rests upon the same grounds as the third, and may be considered a particular application thereof. Pomeroy's Eq.Jur., Vol. I., Sec. 444.

In the case of Lampman vs. Cockran, 16 N.Y., 275, the head not reads as follows: A sum specifically named in

a written agreement "as liquidated damages" in case either party should fail to perform the contract, must, nevertheless, be construed as a penalty, when, upon the face of the instrument, it appears that such sum will necessarily be an inadequate compensation for the breach of some of the provisions and more than enough for the breach of others. A contract provided, among other things, that one of the parties should give to the other, on a specified day, a promissory note for $200, and on a subsequent day a bond and mortgage for $2000 with interest, and the parties agreed therein "to pay one to the other the sum of $500, as liquidated damages," upon failure to perform the contract; HELD, that the sum mentioned is to be regarded as having been wrongly named by the parties, and as being in fact a penalty.

FIFTH. Although an agreement may contain two or more provisions for the doing or not doing different acts still where the stipulation to pay a certain sum of money upon a default, attaches to only one of these provisions, which is of such a nature that there is no certain means of ascertaining the amount of damages resulting from its violation, or

where all of the provisions are of such a nature that the damages occasioned by their breach cannot be measured, and a certain sum is made payable upon a default generally in any of them; in each of these cases the sum so agreed to be paid may be considered as liquidated damages, provided, of course, that the language of the stipulation does not bring it within the limitation of the preceeding fourth rule. It is evident that this proposition, in both its branches, is identical in substance with the second rule heretofore given and rests upon exactly the same grounds. The foregoing rules may be considered as settled by the strong preponderance of judicial authority and they serve to explain large and important classes of cases. There are undoubtedly numerous instances which cannot be easily referred to eith of these rules; and this must be so almost as a matter of necessity. Since agreements are of indefinite variety in their objects and in their provisions, and since the question of penalty or liquidated damages is always one of intention, depending upon the terms and circumstances of each particular contract, there must be many agreements which cannot be brought within the scope of any specific rule, and with which a court can only

deal by applying the most general canon of interpretation. Pomeroy's Eq. Jur., Vol. I., Sec. 445.

It is true the courts in nearly all the cases profess to be construing the contract with reference to the intention of the parties, as if for the purpose of ascertaining and giving effect to that intention; yet it is obvious from the cases, that wherever it has appeared to the court from the face of the contract and the subject matter, that the sum was clearly too large for just compensation, here, while they will allow any form of words, even those expressing the direct contrary to indicate the intent to make it a penalty; yet no form of words, no force of language is competent to the expression of the opposite intent. Here then is an intention incapable of expression in words; and as all written contracts must be expressed in words, it would seem to be a mere waste of time and effort to look for such an intention in such a contract. And as the question is between two opposite intents only, and the negation of one necessarily implies the existence of the other, there would seem to be no room left for construction with reference to the intent.

But some of the cases attempt to justify this mode

of construing the contract with reference to the intent by declaring in substance, that though the language is the strongest which could be used to evince the intention in favor of stipulated damages, still, if it clearly appear by reference to the subject matter that the parties have made the stipulation without reference to the principle of just compensation and so excessive as to be out of all proportion to the actual damage, the court must hold that they could not have intended it as stipulated damages, though they have so expressly declared. Now this, it is true, may lead to the same result in the particular case as to have placed the decision upon the true ground, Viz.- that though the parties actually intended the sum to be paid as the damages agreed between them, yet it being clearly inconscionable, the court would disregard the intention and refuse to enforce the stipulation. But as a rule of construction or interpretation of contracts, it is radically vicious and tends to a confusion of ideas in construction of contracts generally. It is this, more than anything else, which has introduced so much apparent conflict in the decisions upon this whole subject of penalty and stipulated damages. It sets at defiance all rules of interpre-

tation by denying the intention of the parties to be what they in the most unambiguous terms, have declared it to be and finds an intention directly opposite to that which is clearly expressed. Again, the attempt to place this question upon the intention of the parties, and to make this the governing consideration, necessarily implies that, if the intention to make the sum stipulated damages should clearly appear, the court would enforce the contract according to that intention. To test this, let it be asked whether, in such a case, if it were admitted that the parties actually intended the sum to be considered as stipulated damages, and not as a penalty, would a court of law enforce it for the amount stipulated? Clearly, they could not, without going back to the technical and long exploded doctrine which gave the whole penalty of the bond, without reference to the damages actually sustained. They would thus be simply changing the manner of things and enforcing, under the name of stipulated damages, what in its nature is but a penalty. The real question in this class of cases will be founded, but whether the sum is, in fact, in in the nature of a penalty; and this is to be determined by the magnitude of the sum, in connection with the subject

matter, and not at all by the words or understanding of the parties. The intention of the parties cannot alter it.

While the courts of law gave the penalty of the bond, the parties intended the payment of the penalty as such and did not intend the payment of stipulated damages. It must, therefore, we think, be very obvious that the actual intention of the parties in this class of cases, and relating to this point, is wholly immaterial; and though the courts have very generally professed to base their decisions upon the intention of the parties, that intention is not and cannot be made the real basis of their decisions. In endeavoring to reconcile their decisions with the actual intention of the parties, the courts have sometimes been compelled to use language wholly at war with any idea of interpretation and to say "that the parties must be considered as not meaning exactly what they say." May it not be said, with at least equal propriety, that courts have sometimes said what they did not exactly mean! The foregoing remarks are all to be confined to that class of cases where it was clear, from the sum mentioned and the subject matter, that the principle of compensation had been disregarded.

The distinction between a penalty for securing the performance of the contract, and a stipulation which makes pa part of the contract itself, may be illustrated by the rule that if a certain rate of interest is secured in a mortgage, with an agreement that if it be not paid punctually the rate shall be increased, the larger interest is in the nature of a penalty and may be relieved against in equity. But on the other hand, if the larger rate be originally reserved, with an agreement for reduction on punctual payment, the condition for such punctual payment is part of the contract and relief cannot be given if it is not fulfilled.

In the case of Crishe vs. Bolton, 3 Car.& P., 240, Best C.J., says: "That parties to contracts, from knowing exactly their own intention and objects, can better appreciate the consequences of their failing to obtain those objects than either judges or juries; and that if a contract clearly state what shall be paid by the party who breaks it to the party to whose prejudice it is broken, the verdict in an action for the breach should be for the stipulated sum; that a court of justice has no more authority to put a different construction on the part of the instrument ascertaining the

the amount of damages than it has to decide contrary to any other of its clauses. It is conceded by all that courts are to be governed by the intention of the parties, to be gathered from the language of the contract and from the nature and circumstances of the case.

When there is a contract to pay money, the damages for its breach are fixed and liquidated by law, and require no liquidation by the parties. An agreement to pay greater damages is therefore regarded as a penalty. But when the damages resulting from the breach are uncertain in amount, as they are in all other cases, the parties have the right to say how much shall be paid by way of compensation to the party injured; and when they have settled that compensation, neither a court of law nor a court of equity will diminish its amount, unless it be so grossly disproportionate to the actual injury that a man would start at the bare mention of it.

Where there is a manifest difficulty in ascertaining damages arising from the breach of the contract, and the fair conclusion is that the amount is specified and agreed on for the purpose of saving the expense or avoiding the difficulty of proving the actual damages, the parties should be held to

their bargain; and especially where the amount fixed and liquidated is not far beyond what might properly be expected to arise from a breach of the contract.

Where the parties to a contract stipulate for a payment in liquidation of damages by a party in default, if the damages are in their nature uncertain and incapable of exact ascertainment, and may be dependent upon extrinsic consideration and circumstances, and the amount is not, on the face of the contract, out of all proportion to the probable loss, it will be treated as liquidated damages.

The fact that the sum so agreed to be paid is termed by the parties a"penalty" is not controlling upon the question of construction. It seems, however, that when the stipulated sum is disproportionate to the presumed or probable damages, or to a readily ascertainable loss, the courts will treat it as a penalty and will relieve on the principle that the precise sum was not the essence of the agreement, but was in the nature of security for performance.

Plaintiff contracted to erect certain houses for defendant; the contract provided that in case of default in the completion of the work by a certain date, plaintiff,

"the contractor, shall pay to the owner ten dollars for every day thereafter that the said work shall remain unfinished, as and for liquidated damages." Plaintiff failed to perform within the stipulated time, and some time after his default the parties entered into a new agreement, which, after reciting the original contract, the failure to perform, the desire of the contractor for an extension of time, and to avoid the payment of the "penalty", and after specifying what was to be done to entitle plaintiff to a waiver of his default, contained the agreement "that the sum or penalty" due under said contract "shall be $1,540, by way of liquidated damages," unless the work is completed by a day named. The work not having been completed on the day named, the parties entered into another agreement which recited the breach and a claim on the part of the plaintiff that the "penalty" should not be exacted, as his default was excusable, "being caused by an act of God," that is, by a severe storm. The parties agreed thereby to a settlement of all other matter, "except the one question of penalty" leaving that for litigation in case plaintiff chose to litigate the same. In an action brought to determine plaintiff's liability to pay the sum

stipulated, hold, that the sum fixed by the original contract was by way of liquidated damages, not a penalty; that plaintiff's default was not waived by the second contract, but, on the contrary, recognized his liability therefor.

Also, that as the agreement of plaintiff was absolute and no provision was made therein against the result of an interference with its performance by an occurrence unforeseen any beyond plaintiff's control, such an occurrence was not available as a defense. (Head note of Ward vs. H.R.B.Co., 125 N.Y., 230-1).

C O N C L U S I O N .

The author's object in taking this vast and complicated subject was to ascertain whether a particular case, which he has, comes under the head of a Penalty or Liquidated Damages; he has carefully and faithfully examined the rules and authorities applicable thereto and has come to the final conclusion, that no definite rules can be given to ascertain under which head a case comes, and many times it is impossible to tell until the court of last resort has passed upon it.

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