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Liquidated Damages Recovery Under the Restatement (Second) of Contracts

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NOTES

LIQUIDATED DAMAGES RECOVERY UNDER THE RESTATEMENT (SECOND) OF CONTRACTS

Liquidated damage recovery has long been a source of confusion for courts and private parties alike.[1] Through the years a constant tension has divided the competing policies of encouraging parties' freedom to contract and analyzing the equities involved in each case. While in earlier years courts struck down all liquidated damage clauses as penalties, in this century courts began encouraging parties to fix their damage exposure in advance.[2] The Restatement (Second) of Contracts marks another step in changing liquidated damage clause analysis.[3] Following the Uniform Commercial Code's approach to liquidated damages,[4] the *Restatement Second* allows a party to assert as a defense the absence of any actual damages which, if successful, will void an otherwise valid liquidated damage clause. Codified standards for a defense of no actual damages are long overdue. The *Restatement Second* may reduce the widespread confusion in this area.

I
HISTORY

A. *Case Law Prior to the First Restatement of Contracts*

Historically, courts have had difficulty distinguishing penalties from valid liquidated damage clauses. In early English legal history, parties used penal bonds to secure performance of a contract.[5] Upon a breach, the entire amount of the bond was due immediately, regardless of the actual damage suffered.[6] Courts sitting in equity, however, had jurisdiction to intervene and mitigate the harsh results where the breach

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1 In Giesecke v. Cullerton, 280 Ill. 510, 513, 117 N.E. 777, 778 (1917), the court observed:

> [N]o branch of the law is involved in more obscurity by contradictory decisions than whether a sum specified in an agreement to secure performance will be treated as liquidated damage or a penalty, and that each case must depend upon its own peculiar and attendant circumstances, and that therefore general rules of law on this subject are very often of very little practical significance.

2 *See* RESTATEMENT OF CONTRACTS § 339(1) (1932); notes 41-49 and accompanying text *infra.*

3 RESTATEMENT (SECOND) OF CONTRACTS § 356(1) (1979); *see* notes 86-102 and accompanying text *infra.*

4 U.C.C. § 2-718(1).

5 3 S. WILLISTON, CONTRACTS § 774 (1920).

6 *Id. See also* Fletcher v. Dyche, 100 Eng. Rep. 18, 21 (1787) (agreement to pay stipu-

did not cause any actual damage.[7] Eventually, legislatures in both England and the United States curtailed the use of penal bonds.[8]

American courts recognized the parties' right to set damages in advance of a breach, and distinguished valid clauses from penalties.[9] These courts allowed recovery where the parties had attempted to reasonably estimate in advance the damages that might result from a breach.[10] In contrast, where the preset damages were "disproportionate to the damage which could have been anticipated from breach of the contract, and which [were] agreed upon in order to enforce performance . . .,"[11] the courts labeled the clause an "unenforceable penalty."[12]

B. *The Conflicting Policies on the Role of Actual Damages*

1. *Freedom of Contract*

Judicial encouragement of freedom of contract has been important throughout American legal history.[13] In the area of liquidated damages, this encouragement translated into enforcement of liquidated damage clauses if the parties, at the time of contracting, reasonably tried to estimate possible harm from a breach.[14] Courts and commentators posited

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lated sum each week that work is unfinished valid regardless of work's nearness to completion).

7 3 S. WILLISTON, CONTRACTS §§ 774-775 (1920). *See also* Kemble v. Farren, 130 Eng. Rep. 1234 (1829) (liquidated damages clause void unless clause specifies stipulations in agreement to which liquidated damages apply).

8 3 S. WILLISTON, CONTRACTS § 774 (1920).

9 *See* Sun Printing & Publishing Ass'n v. Moore, 183 U.S. 642, 660-61 (1901) (detailing history of penal bonds in England to disprove argument that courts may void sum disproportionate to actual loss); Bignall v. Gould, 119 U.S. 495, 498 (1886) ("Whoever framed this agreement does not appear to have had any very clear idea of the distinction between a penalty and liquidated damages. . . ."); Chicago House-Wrecking Co. v. United States, 106 F. 385, 389 (1901) ("The parties cannot, by calling the sum mentioned 'stipulated damges,' change what is essentially a penalty."); 3 S. WILLISTON, CONTRACTS § 778 (1920) ("[W]hen contracts are drawn by lawyers the sum stipulated for is usually called liquidated damages, but courts rightly pay little attention to the name given to a sum payable in terms on a breach of contract.").

10 *See, e.g.,* United States v. Bethlehem Steel Co., 205 U.S. 105 (1907); Friek v. Rubel Corp., 62 F.2d 765 (2d Cir. 1933); Ellicott Mach. Co. v. United States, 43 Ct. Cl. 232 (1908). Early courts were concerned with ensuring that the breach, which would trigger a liquidated damages clause, was narrowly defined in the contract so that a minor breach would not result in the full liquidated damages recovery. *See* Biguall v. Gould, 119 U.S. 495 (1886); Kemble v. Farren, 130 Eng. Rep. 1234 (1829).

11 *See* Bignall v. Gould, 119 U.S. 495 (1886) ("liquidated damages" clause held to be penalty).

12 Chicago House-Wrecking Co. v. United States, 106 F. 385 (1901) ("stipulated damages" held to be penalty); Caesar v. Rubinson, 147 N.Y. 492, 67 N.E. 58 (1903) ("liquidated damages" clause in lease held to be penalty).

13 The freedom of contract theory was developed in a line of Supreme Court cases.

14 Wise v. United States, 249 U.S. 361, 365 (1919) (intention of parties when contract made); Sun Printing & Publishing v. Moore, 183 U.S. 642, 662 (1902) ("[T]his court has consistently maintained the principle that the intention of the parties is to be arrived at by a proper construction of the agreement made between them. . . .").

that an unexpected turn of events resulting in no actual damage was simply a risk of doing business.[15] Nonenforcement of a valid liquidated damage clause for lack of actual damage was therefore an infringement on the parties' freedom of contract.[16] These courts limited their function to weeding out cases of fraud or coercion in the original contact.[17] The courts' emphasis on the parties' freedom of contract often resulted in upholding liquidated damage clauses where little or no damage actually occurred.[18]

Many courts relied on Supreme Court cases that had upheld liquidated damage clauses in the absence of actual damage on freedom of contract grounds.[19] The landmark case is *United States v. Bethlehem Steel Co.*[20] In *Bethlehem Steel*, Bethlehem Steel had contracted to sell gun carriages to the government for use in the Spanish-American War. Because time was of the essence for the government, the parties inserted a fairly-bargained[21] liquidated damage clause of thirty-five dollars per gun carriage for each day's delay.[22] Although the war ended before performance on the contract became due, the government still sought to enforce the liquidated damage clause when Bethlehem Steel failed to deliver the guns on time.[23]

The Supreme Court examined the parties' intent at the time of contracting and determined that the clause was a fair estimate of the harm that might have resulted from the failure to deliver in a timely man-

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15 C. MCCORMICK, DAMAGES § 150 (1935). *See also* McCarthy v. Tally, 46 Cal. 2d 577, 297 P.2d 981 (1956).

16 *See* Stephens v. Essex Co. Park Comm'n, 143 F. 844 (3d Cir. 1906); Byron Jackson Co. v. United States, 35 F. Supp. 665 (S.D. Cal. 1940); Parker-Washington Co. v. City of Chicago, 267 Ill. 136, 107 N.E. 872 (1915).

17 *See, e.g.*, Sun Printing & Publishing Ass'n v. Moore, 183 U.S. 642, 669-70 (1902) ("If they are competent to contract within the prudential rules the law has fixed as to parties, and there has been no fraud, circumvention or illegality in the case, the court is bound to enforce the agreement.").

18 *See, e.g.*, Ellicott Mach. Co. v. United States, 43 Ct. Cl. 232 (1908); Byron Jackson Co. v. United States, 35 F. Supp. 665, 667 (S.D. Cal. 1940) (Although the government admitted total absence of damages, "recovery of liquidated damages is allowed upon mere proof of an explicit contractual undertaking to that effect. No proof that, in fact, damage did not flow from the breach is allowed.").

19 Rex Trailer v. United States, 350 U.S. 148 (1956); Wise v. United States, 249 U.S. 361 (1919); United States v. Bethlehem Steel, 205 U.S. 105 (1907); Sun Printing & Publishing Ass'n v. Moore, 183 U.S. 642 (1901).

20 205 U.S. 105 (1907).

21 *Id.* at 106-14. The parties agreed to set the liquidated damages clause amount equal to the average difference between the contract price and the price that Bethlehem Steel had submitted as a bid when it contemplated later delivery. The parties corrected an error in the computation of the damage amount prior to signing the contract. From the correspondence between the two parties, *id.*, it appears that Bethlehem Steel was fully aware of the terms of the provision.

22 *Id.* at 118.

23 *Id.*

ner.[24] Accordingly, the Court held that the clause was valid and enforceable despite the lack of actual damage.[25] In so holding, the Court stressed the importance of freedom to contract.[26]

The holding in *Bethlehem Steel* is justified more by the unique characteristics of government contracts than by the policy of enforcing the parties' freedom to contract. Arguably, government contracts during wartime require greater certainty than an ordinary commercial contract.[27] Peacetime government contracts also pose unique problems of quantifying the actual damage of delay in completing a public work.[28] Subsequent reliance on *Bethlehem Steel* and later Supreme Court cases

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24 *Id.* at 119, 121.

25 *Id.* at 119. The Supreme Court focused only on what the party had intended at the time of contracting. The Court stated: "When such intention is ascertained, it is ordinarily the duty of the court to carry it out." *Id.*

26 The Court explaincd:

> courts have now become strongly inclined to allow parties to make their own contracts, and to carry out their intentions, even when it would result in the recovery of an amount stated as liquidated damages, upon proof of the violation of the contract, and without proof of the damages actually sustained.

Id.

27 As Justice Frankfurter suggested in his strongly-worded dissent in Priebe & Sons, Inc. v. United States, 332 U.S. 407, 417 (1947), wartime government contracts have diffcrent salient features and should be governcd by different policy considerations than ordinary commercial contracts. *Id.* at 419-21. *Priebe* involved a government contract for the delivery of dried eggs and provided for liquidated damages in case of failure to obtain inspection certificates by a specified date. Although Priebe & Sons failed to obtain the certifieates on time, the delivery schedule was not impaired. The majority held that the clause was void as a penalty because the government could not have foreseen a monetary loss resulting from delay of the intervening steps necessary for delivery. *Id.* at 413. Justice Frankfurter acknowledged that the reasoning of the majority would apply in the context of an ordinary commercial contract, but concluded that the wartime government contract setting justified a contrary result. *Id.* at 419-21.

Strong reasons support treating wartime governmcnt contract cases differently from ordinary commercial transactions. First, as Justice Frankfurter points out in *Priebe,* the need for certainty in a wartime government procurement contract is stronger than in ordinary contracts. *Id.* at 419. The success of a war effort may depend on timely fulfillmcnt of these contracts. Second, beeause the provisions of government contracts are standardized through legislative guidelines, both sides have knowledge of the terms, and the element of unfair surprise that may characterize private contracts is missing. In federal construction contracts, for example, a per diem damages clause for delay is standard practice. These amounts are specified by law in the bid documents that all prospective contractors receive. *See* Federal Procurement Regulations, 41 C.F.R. § 1-1.315-3(b), 1-8.700 (1981); Gantt & Breslauer, *infra* note 29, at 74; Peckar, *Liquidated Damages in Federal Construction Contracts: Time for a New Approaeh,* 5 PUB. CONT. L.J. 129, 130-31 (1972). Third, determining the amount of damages that might fiow from a government contract, particularly one involving national defense, is extremely difficult. Damages for failure to supply clothing, equipment, planes, or food during wartime cannot be objectively measured. *See* United States v. Walkof, 144 F.2d 75, 77 (2d Cir. 1944) (liquidated damages clause for delay in providing overalls to War Department upheld, despite availability of comparable items, because late delivery might have caused difficulties in the war effort).

28 *See.* Bethlehem Steel Co. v. City of Chieago, 234 F. Supp. 726, 729 (N.D. Ill. 1964) (difficulty of quantifying actual damages where superhighway delayed), *aff'd,* 350 F.2d 649 (7th Cir. 1965); Peckar, *supra* note 27, at 130.

involving government contracts[29] was therefore misplaced when applied indiscriminately to liquidated damage clauses.

An evidentiary rule arose as a corollary to the freedom of contract analysis. Because the plaintiff need not plead or prove actual damage in order to recover, the defendant could not introduce evidence of the absence of damage.[30] This evidentiary rule expedited resolution of certain cases. Parties commonly use liquidated damages clauses when damages will be either uncertain in amount or unascertainable. Enforcement of these clauses when damage obviously existed thus greatly reduced the time and expense of litigation. In cases of little or no actual damage, however, the court had no evidence from which to judge the extent of damage. The latter setting and its potential for injustice led certain courts away from strict enforcement of the parties' freedom of contract in ordinary commercial cases.[31]

2. *The Equitable Rule*

Where the actual damage resulting from a breach was small or nonexistent, some courts used equitable principles to avoid enforcing a liquidated damage clause.[32] When the parties had made a reasonable estimate of the possible harm from a breach, yet through some unforeseen contingency there were no damage, "the expressed intent of the parties [was] made to give way to the equity of the particular case . . . ."[33] In this manner, selective judicial enforcement of otherwise valid liquidated damage clauses prevented unjustly enriching the bene-

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29 For examples of government contracts resulting in little or no actual damage that were upheld on the authority of *Bethlehem Steel,* see Southwest Eng'r Co. v. United States, 341 F.2d 998 (8th Cir.), *cert. denied,* 382 U.S. 819 (1965); United States v. LeRoy Dyal Co., 186 F.2d 460 (3d Cir. 1950), *cert. denied,* 341 U.S. 926 (1951)); *In re* Lion Overall Co., 55 F. Supp. 789 (S.D.N.Y. 1943), *aff'd sub nom.* United States v. Walkof, 144 F.2d 75 (2d Cir. 1944). *See also* Gantt & Breslauer, *Liquidated Damages in Federal Government Contracts,* 47 B.U. L. REV. 71 (1967).

30 *See* Stephens v. Essex Co. Park Comm'n, 143 F. 844 (3d Cir. 1906); Byron Jackson Co. v. United States, 35 F. Supp. 665 (S.D. Cal. 1940); Parker-Washington Co. v. City of Chicago, 267 Ill. 136, 107 N.E. 872 (1915). *But see* 5 S. CORBIN, CONTRACTS § 1062 (1935) (supporting view that defendants should be allowed to introduce evidence on lack of damages).

31 *See* note 33 and accompanying text *infra.*

32 *See* Priebe & Sons, Inc. v. United States, 332 U.S. 407 (1947) (liquidated damages clause for delays in obtaining inspection certificates void as penalty; goods were ultimately delivered promptly); Massman Constr. Co. v. City Council of Greenville, 147 F.2d 925 (5th Cir. 1945) (liquidated damages clause for delays in construction of bridge void as penalty despite delay in construction; bridge finished 30 days before road leading to it); The Colombia, 197 F. 661 (S.D. Ala. 1912) (liquidated damages clause for delay in repairs of ship not enforced; no evidence ship could have been on water earning profit during delay period); Gay Mfg. Co. v. Camp., 65 F. 794 (4th Cir. 1895) (liquidated damages clause for 15-day delay in rent payments not enforced; entire 2-year lease paid after suit instituted).

33 Seeman v. Biemann, 108 Wis. 365, 373, 84 N.W. 490, 492 (1900). The circuit court in Harris v. Miller, 11 F. 118, 121 (C.C.D. Or. 1880), stated that "[u]pon this subject the law is peculiar, and, instead of giving effect to the contract of the parties according to their intentions, it assumes to control them according to its standard of justice."

ficiaries of the clause.[34] Because some courts did not adopt this policy and strictly followed the government-contract cases holding freedom of contract paramount,[35] the results of cases where subsequent events revealed no actual damage were extremely unpredictable.[36]

II
THE FIRST RESTATEMENT OF CONTRACTS

The first Restatement of Contracts[37] favored the common-law policy of freedom of contract rather than an individual analysis of the actual harm in each case. The first *Restatement* thus followed the common law's focus on the parties' intent at the time of contracting.[38] Few courts under the *Restatement* considered the equitable position of the parties in order to invalidate the damage clause where no actual damage resulted

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34 [C]onceding the rule to be that, in order to recover a sum as liquidated damages, it is unnecessary to prove actual damage, it is also true that no provision in a contract for the payment of a fixed sum as damages, will be enforced in a case where the court can see that no damages have been sustained.

NorthWest Fixture Co. v. Kilbourne & Clark Co., 128 F. 256, 261 (9th Cir. 1904); *see* Seeman v. Biemann, 108 Wis. 365, 373-74, 84 N.W. 490, 492 (1900) ("While courts adhere to the doctrine that the intention of the parties must govern . . . , they uniformly take such liberties in regard to the matter . . . , as may be necessary to effect judicial notions of equity . . . where otherwise an unconscionable advantage would be obtained by one person over another.").

35 *See* notes 13-31 and accompanying text *supra.*

36 Occasionally the courts' insistence on actual damage caught the parties by surprise, and the results of cases were not always dictated by fairness. In McCann v. City of Albany, 158 N.Y. 634, 53 N.E. 673 (1899), the defendant city was apparently unaware that it might be required to show actual damages in a case where the plaintiff contractor clearly had delayed completion of a sewer. The New York Appellate Division affirmed the decision of a special referee that the liquidated damages clause should not be enforced, but did so on the ground that the city suffered only nominal damage. The city appealed, claiming that the issue of damages was never brought up in trial, and that, if given a chance, it could show actual damages. The New York Court of Appeals, although agreeing that the issue had never come up in trial, held that the city "elected to defend the action as to this item upon the theory that it was entitled to the entire sum . . . , without reference to the actual damages sustained by it. . . ." 158 N.Y. at 640, 53 N.E. at 674. Given the prevalence of the view that parties' freedom of contract should be upheld, the city's failure to allege or prove actual damage is understandable.

37 Section 339(1) provided:

> An agreement, made in advance of breach, fixing the damages therefor, is not enforceable as a contract and does not affect the damages recoverable for the breach, unless
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> (a) the amount fixed is a reasonable forecast of just compensation for the harm that is caused by the breach, and (b) the harm that is caused by the breach is one that is incapable or very difficult of accurate estimation.

38 *See* United States v. J.D. Streett & Co., 151 F. Supp. 469, 472 (E.D. Mo. 1957) (liquidated damages provisions must be judged as of the time of contracting); Byron Jackson Co. v. United States, 35 F. Supp. 665; 667 (S.D. Cal. 1940) (federal law only allows consideration of evidence of intent at time of contracting); United States v. United States Fidelity & Guar. Co., 35 F. Supp. 959 (E.D. Pa. 1940) (bond in case of breach valid because valid at time of contract).

from the breach.[39]

Section 339 of the first *Restatement* contained a two-part test for determining the validity of a liquidated damage clause. First, section 339(1)(a), the "intent of the parties" test,[40] required the amount of damages to be "a reasonable forecast of just compensation for the harm that is caused by the breach."[41] Commentators criticized the "intent" test as circular;[42] if the court wanted to enforce the clause, the parties "intended" a liquidated damage clause, and if the court wanted to invalidate the clause, the parties "intended" a penalty.[43] Most courts, however, followed the literal language of the first *Restatement,* and evaluated the parties' intent at the time of contracting.[44]

The second part of the *Restatement*'s test provided that the harm caused by the breach must be "incapable or very difficult of accurate estimation."[45] This language caused confusion by failing to indicate the time frame courts should use in determining whether the damages were difficult to ascertain. Arguably, courts could have used the time of the trial as the proper point for assessing the difficulty of ascertaining damages, and thereby allowed a defense of no actual damages.[46] The Illus-

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39 *See* notes 60-62 *infra.*

40 5 S. WILLISTON, CONTRACTS § 778 (1961). Labelling the first *Restatement* test an "intent test" was something of a misnomer, for the actual intent of the parties was often largely irrelevant. The crucial consideration in this analysis, rather, was the reasonableness of the parties' efforts to forecast the damage from a breach. The courts' tendency to downplay the parties' intent can be seen in those cases where they enforced a pre-estimated damages clause, even though called a "penalty" in the contract. *See, e.g.,* United States v. Bethlehem Steel Co., 205 U.S. 105, 115 (1907) ("penalty" for delay in delivery of gun carriages upheld); Massman Constr. Co. v. City Council of Greenville, 147 F.2d 925, 928 (5th Cir. 1945) ("liquidated damages clause" for delay in completion of bridge void as penalty); Blewett v. Front St. Cable Ry., 51 F. 625, 627-28 (9th Cir. 1892) (bond-fixing "penalty" in case of breach upheld); Bauer v. Sawyer, 8 Ill. 2d 351, 134 N.E.2d 329 (1956) (liquidated damages clause in partnership agreement restricting area in which withdrawn partner could practice void as penalty).

41 RESTATEMENT OF CONTRACTS § 339(1)(a) (1932); *see* 5 S. WILLISTON, CONTRACTS § 777 (1961).

42 *See* Dunbar, *Drafting the Liquidated Damage Clause—When and How,* 20 OHIO ST. L.J. 221 (1959).

43 Note, *UCC 2-718(1): Attorney's Fees as Liquidated Damages in New York,* 51 ST. JOHN'S L. REV. 100, 106 (1976).

44 *See* United States v. J.D. Streett & Co., 151 F. Supp. 469, 472 (E.D. Mo. 1957) (liquidated damages provisions must be judged as of time of contracting); United States v. United States Fidelity & Guar. Co., 35 F. Supp. 959 (E.D. Pa. 1940) (bond in case of breach valid because valid at time of contract); Byron Jackson Co. v. United States, 35 F. Supp. 665, 667 (S.D. Cal. 1940) (federal law only allows consideration of evidence of intent at time of contracting).

45 Section 339(1)(b) provides: "[T]he harm that is eaused by the breach is one that is ineapable or very difficult of accurate estimation."

46 Illustration 2 to § 339, for example, presents a situation in which "[t]he harm eaused to A . . . is incapable of computation with reasonable accuracy even after the breach had occurred." RESTATEMENT OF CONTRACTS § 339, Illustration 2 (1932). For examples of courts using the time of contracting as the vantage point for evaluating parties' intent, see Robbins v. Plant, 174 Ark. 639, 297 S.W. 1027 (1927); Better Foods Mkts., Inc. v. American Dist. Tel. Co., 40 Cal. 2d 179, 184-85, 253 P.2d 10, 14 (1953); Bauer v. Sawyer, 8 Ill. 2d 351,

trations to section 339, however, indicated a contrary result by disallowing this defense in fact patterns in which it would have been applicable.[47]

The drafters of the first *Restatement* included additional material that also suggested a no actual damage defense. Comment e stated that if "the parties honestly but mistakenly suppose that a breach will cause harm . . . when in fact the breach causes no harm at all," the contract sum is not enforceable. "Evidence to prove such a mistake" the Comment continues, "is admissible."[48] Courts therefore could have used the factual-mistake doctrine to admit evidence of a lack of actual damage. Despite the addition of this Comment, however, many courts interpreted the test of the first *Restatement* to prohibit admission of evidence of actual damage or of the lack thereof.[49] This result was apparently not

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134 N.E.2d 329 (1956); Prentice, *Liquidated Damages in Illinois,* 31 ILL. L. REV. 879, 885 (1936) ("validity of the stipulation must be judged as of the time when the contract was entered into"). *Contra* Sweet, *Liquidated Damages in California,* 60 CALIF. L. REV. 84, 131-32 (1972) (courts should emphasize "time of trial").

47 Illustration 3 to § 339, for example, gives a common fact pattern involving a contract, containing a per diem damage clause for delay, to construct a grandstand. The Illustration concludes: "Evidence that B could not have used the grandstand for spectators during the period of delay is not sufficient to show that the delay caused no injury or that the harm is capable of accurate estimation." RESTATEMENT OF CONTRACTS § 339, Illustration 3 (1932). It is difficult to imagine a clearer case of no damages. This particular fact pattern arises most often in bridge-construction contracts, where the bridge is not finished on time and per diem damages are assessed although the road to the bridge is also not completed on time. For examples of this fact pattern, see Massman Constr. Co. v. City Council of Greenville, 147 F.2d 925 (5th Cir. 1945); Bethlehem Steel Co. v. City of Chicago, 234 F. Supp. 726 (N.D. Ill. 1964), *aff'd,* 350 F.2d 649 (7th Cir. 1965). Illustration 7 states:

> A offers to manufacture and deliver to the B Government specified guns at $5000 each if delivered by May 1, or at $4000 each if delivered 100 days later. B accepts the first offer at the higher price; but it is mutually agreed that in case of delay beyond May 1 the price to be paid shall be reduced by $10 for each day's delay. If the guns are not delivered until 30 days after May 1, B is bound to pay no more than $4700, since that sum is the agreed price. Evidence offered by A that the war is over and that the delay has caused no harm is wholly immaterial.

RESTATEMENT OF CONTRACTS § 339, Illustration 7 (1932). This Illustration presents the essential facts of United States v. Bethlehem Steel Co., 205 U.S. 105 (1907). *See* notes 20-26 and accompanying text *supra.* The *Bethlehem Steel* Court also did not look to evidence of actual damage.

48 RESTATEMENT OF CONTRACTS § 339, Comment e (1932).

49 McCarthy v. Tally, 46 Cal. 2d 577, 297 P.2d 981 (1956) is a classic case relying solely upon the reasonableness of the sum as of the time of contracting. The court, relying on *Bethlehem Steel* and the first *Restatement,* invoked the strict rule that no evidence of actual damage could be admitted, because the intent of the parties cannot depend on events subsequent to the contract. *Id.* at 986. For a discussion of this case, see Note, *Contracts: Liquidated Damages: Necessity of Actual Damages,* 4 U.C.L.A. L. REV. 126 (1956). *See also* United States v. Glens Falls Indem. Co., 152 F. Supp. 840 (S.D.N.Y. 1957); United States v. J.D. Streett & Co., 151 F. Supp. 469 (E.D. Mo. 1957); McCarthy v. Tally, 46 Cal. 2d 557, 297 P.2d 981 (1956); Byron Jackson Co. v. United States, 35 F. Supp. 665 (S.D. Cal. 1940); United States v. United States Fidelity & Guar. Co., 35 F. Supp. 959 (E.D. Pa. 1940); Nester v. Western Union Tel., 25 F. Supp. 478 (S.D. Cal. 1938).

intended by Professor Corbin who, although not favoring frequent use of a no actual damages defense, later wrote that "it is not necessary or desirable to say that [liquidated damage clauses] . . . are enforceable even though the plaintiff has in fact suffered no harm whatever, or to lay down an absolute rule that the defendant can never introduce any evidence as to the total absence or definitely limited extent of injury suffered."[50]

As in the pre-*Restatement* era, some courts took judicial notice of the lack of actual damage and decided each case on the individual equities. *Norwalk Door Closer Co. v. Eagle Lock & Screw Co.*,[51] typifies this minority view. In *Norwalk,* the court refused to enforce a liquidated damage clause to which the parties had reasonably agreed, on the grounds that there was no actual damage.[52] The court held that the clause must be reasonable, not only at the time of contracting, but also at the time of enforcement.[53] The *Norwalk* case and other decisions like it contravened decisions of courts following the first *Restatement* command to give effect to the intent of the parties as viewed from the time of contracting.[54]

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50 5 A. CORBIN, CONTRACTS § 1062 (1964). Each Restatement is the work of several authors. Comment e is a holdover from Reporter Williston's original, tentative draft, which explicitly advocated looking at the damages at the time of breach to determine if the parties had contracted for a penalty or a valid liquidated damage clause. RESTATEMENT OF CONTRACTS (ALI Confidential Preliminary Draft No. 36) (Apr. 15, 1929) (available at Cornell Law School Library). Examination of the tentative drafts of the first *Restatement* reveals that Reporters Williston and Corbin did not intend to preclude admission of the lack of actual damage to show that the stipulated sum was disproportionate to the actual harm. *Id.* (Notes by George Jarvis Thompson) available at the Cornell Law School Library). The text omitted mention of actual damage because, as Corbin explained it, "I wanted to make it more certain . . . that the courts would not use my rule in such a way as to let one of the parties by trying to prove there was not any injury at all substantially nullify and prevent all benefit from a liquidated damage provision." 10 ALI PROCEEDINGS 181 (1932). Courts, however, focused on the *Restatement*'s Illustrations to exclude all evidence of lack of actual damages.

51 153 Conn. 681, 220 A.2d 263 (1966).

52 *Id.* at 688, 220 A.2d at 267.

53 In an attempt to ground the decision in established case law, the court cited *Restatement* § 339, Comment e and Priebe & Sons v. United States, 332 U.S. 407, 412 (1947), for the proposition that equitable principles prevented recovery when no damage had occurred. 153 Conn. at 688, 220 A.2d at 268.

54 5 S. WILLISTON, CONTRACTS § 778 (1961). For example, Massman Constr. Co. v. City Council of Greenville, 147 F.2d 925 (6th Cir. 1945), and Bethlehem Steel Co. v. City of Chicago, 350 F.2d 649 (7th Cir. 1965), are two cases very similar on their facts that reached contrary results. Both cases concerned construction contracts containing a liquidated damages clause of per diem damages for delay. In *Massman,* although the contractor delayed completion for 96½ days, the bridge was actually finished 30 days before it could be used, beeause the road leading to the bridge was not yet complete. The court allowed the contractor to defend on the ground of lack of actual damage, reasoning that the clause was intended to guard against losses resulting from delays in completion. The clause was premised on the assumption that delays would result in damage; when the assumption failed, the clause was void.

In *City of Chicago,* the steel work for a section of highway was delayed 52 days, although the state opened the highway route on schedule. As in *Massman,* the stated purpose of the liquidated damages clause was to guard against delays in completing and opening of the

The Restatement of Contracts, therefore, failed to resolve the conflict between judicial adherents to the freedom of contract approach and those courts that adopted an equitable perspective.

III
U.C.C. § 2-718(1)

Section 2-718(1) of the Uniform Commercial Code was the first legislative attempt to inject more flexibility into judicial interpretation of liquidated damage clauses. It reads:

> 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.[55]

The UCC departs from the common-law treatment of liquidated damages in several ways. First, the "intention of the parties" test[56] is abandoned entirely. Second, the UCC text establishes that evidence of actual damages or the lack thereof may be relevant in determining the validity of the liquidated-damage clause.[57]

Courts and commentators have interpreted the phrase "anticipated or actual harm" in two ways. The first interpretation reads section 2-718(1) to require evaluation of the liquidated damage clause in light of anticipated and actual loss.[58] Under this test, the defendant must prove the absence of damage.

This interpretation of the UCC unites the two methods of analysis that courts have historically used: not only must the parties attempt at the time of contracting to provide a reasonable estimate of probable harm, but the sum specified also must be reasonable in light of actual harm. Theoretically, a liquidated damage clause may be an unreasonable forecast of possible damage yet, due to unforeseen circumstances, may become a valid approximation of actual damage.[59] The first inter-

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highway. The *City of Chicago* court, upholding the right of parties to contract freely, enforced the clause, finding the measure of actual loss irrelevant. Because the clause was a reasonable forecast as of the time it was entered into, it was valid and enforceable.

55 U.C.C. § 2-718(1).

56 *See* notes 40-45 *supra.*

57 *But see* Macneil, *Power of Contract and Agreed Remedies,* 47 CORNELL L.Q. 495, 505 n.31 (1962) (UCC supports strict rule of McCarthy v. Tally, 46 Cal. 2d 577, 297 P.2d 981 (1956), excluding all evidence of actual damages from consideration).

58 *See* Norwalk Door Closer Co. v. Eagle Lock & Screw Co., 153 Conn. 681, 220 A.2d 263 (1966); notes 60-62 and accompanying text *supra.*

59 The problem of compensating the plaintiff for damages unforeseen by both parties at the time of contracting is an old one in the field of contract law. *See* Hadley v. Baxendale, 9 Ex. 341 (1854).

pretation of the UCC precludes recovery of liquidated damage in this situation, because the sum is disproportionate to anticipated damage.

Problems with this interpretation are numerous. First, it eviscerates the purpose of liquidated damage clauses, which is to allow parties to avoid expensive and difficult litigation over contract damages. With this interpretation, every case involving liquidated damages would require an inquiry into the actual damage.[60] Second, this interpretation renders the second sentence of 2-718(1) superfluous. If the first sentence of section 2-718(1) voids all damage clauses that are not reasonable at the time of trial, then the second sentence, which states that "unreasonably large liquidated damages [are] void as a penalty,"[61] adds nothing.

The second interpretation follows the language of the UCC more faithfully. Under this interpretation, "anticipated or actual harm" in the first sentence of section 2-718(1) allows the courts to enforce a liquidated damage clause that *either* reasonably estimates the likely harm *or* accurately reflects the actual harm.[62] The second sentence will operate to invalidate those clauses that reasonably estimated likely harm, but turn out to be unreasonably large when compared to actual damage.[63] This second interpretation, however, would allow enforcement of a clause unreasonable at the time of contracting, but reasonable in light of actual damage.[64]

The UCC sets forth two additional factors to consider in determining the enforcement of a liquidated-damage clause: "the difficulties of proof of loss, and the inconvenience or non-feasibility of otherwise obtaining an adequate remedy."[65] The second factor appears merely to restate the first; it adds nothing and courts have not decided cases based upon the phrase. The requirement that a liquidated damage clause be reasonable in light of "difficulties of proof of loss" is ambiguous because

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60 *See* Note, *A New Standard for Liquidated Damage Provisions Under the Uniform Commercial Code,* 38 OHIO ST. L.J. 437, 454-55 (1977).

61 U.C.C. § 2-718(1).

62 *See* A. CORBIN, CONTRACTS § 1063 (Kaufman Supp. 1980); W. HAWKLAND, A TRANSACTIONAL GUIDE TO THE U.C.C. 170-72 (1964); Note, *Liquidated Damages and Penalties Under the Uniform Commercial Code and the Common Law: An Economic Analysis of Contract Damages,* 72 NW. U.L. REV. 1055, 1074-75 (1972).

63 Comment 1 suggests that if the clause is disproportionately small, unconscionability provides the remedy. This approach is the one taken by the Restatement (Second) of Contracts, although very few courts have embraced this position.

64 The second interpretation does not adequately address the problems raised by Hadley v. Baxendale, 9 Ex. 341 (1854), of the foreseeability of damages. When Prof. Farnsworth, Reporter for the *Restatement Second,* was asked about the situation in which a clause that is unreasonable in terms of anticipated harm becomes enforceable because of the actual harm, he pointed out that the UCC had not adequately resolved this problem, and concluded that "I confess that I don't know a lot of hard authority on that." 56 A.L.I. PROCEEDINGS 366 (1979); *see* Note, *supra* note 60, at 437 (1977) (discussion of the time of reasonableness problem under the UCC).

65 U.C.C. § 2-718(1).

it does not specify a time when these difficulties must arise.[66]

Very few cases have discussed the UCC provision on liquidated damages.[67] Perhaps because of the terse language of 2-718(1), most courts have not mentioned the section entirely, relying on common-law principles dating from the first *Restatement.*[68] When they mention it at all, the courts view the UCC test as requiring a general "reasonableness" approach to all facets of the case.[69]

The UCC treatment of liquidated damages has also done little to resolve the question of the role of actual damages resulting from the breach. The courts remain divided over the role of actual harm when evaluating a liquidated damages clause. A few retain the strict first *Restatement* rule and allow no evidence of actual damage.[70] Most appear confused over the role of actual damage in the reasonableness

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66 *Id.*; *see* Comment, *Liquidated Damages: A Comparison of the Common Law and the Uniform Commercial Code,* 45 FORDHAM L. REV. 1349, 1358-59 (1977).

67 The only case to date that has dealt with § 2-718(1) in depth, Equitable Lumber Corp. v. I.P.A. Land Dev. Corp., 38 N.Y.2d 516, 344 N.E.2d 391, 381 N.Y.S.2d 459 (1976), apparently chose the second interpretation. *Equitable Lumber* concerned a liquidated damages clause for an award of attorney fees. The clause provided that if the buyer breached the contract, he would pay a "reasonable" attorney fee, set at 30% of the total money recovered. The lower court awarded plaintiff nearly $4,000, but declined to enforce the 30% figure, because a maximum of 10 hours of attorney time was needed to collect the judgment. It therefore awarded fees of $450, or about 11%. The appellate court modified the award to $750.

The Court of Appeals of New York reasoned that U.C.C. § 2-718(1) required the court to determine whether the liquidated damages clause was reasonable in light of either the anticipated harm or the actual damage. The court then reasoned that even if the clause met the first test of reasonableness, the second sentence of U.C.C. § 2-718(1) required a determination of whether the liquidated damages were "unreasonably large" with respect "to the damages which plaintiff was likely to suffer from the breach in the event it did rely on [the liquidated damages] agreement." The court, therefore, did not have to enter into a discussion of the actual/anticipated harm test no "difficulties of proof of loss" arose. Attorney fees are readily determinable damages, and the clause could have been void on this point alone. The *Equitable Lumber* interpretation is not without controversy. *See* A. CORBIN, CONTRACTS § 1063 (Kaufman Supp. 1980).

68 For example, the court in Grumman Flexible Corp. v. City of Long Beach, 505 F. Supp. 623 (E.D.N.Y. 1980) relied on Cotheal v. Talmage, 9 N.Y. 551 (1854), for the notion that when the contract is signed, anticipated damages must be incapable of accurate estimation. The *Grumman* court also relied on Brecher v. Laikin, 430 F. Supp. 103 (S.D.N.Y. 1977) for the proposition that the amount must not be disproportionate to the damage reasonably anticipated. *Brecher* had relied on cases dating from before 1925 whose common-law principles have been substantially modified by the UCC and the *Restatement Second.* For other cases decided on authority other than the UCC, see Mann & Parker Lumber Co. v. Wel-Dri, 579 F.2d 973 (6th Cir. 1978); Walker v. First Pa. Bank, N.A., 518 F. Supp. 347 (E.D. Pa. 1981); Gorman Publishing Co. v. Stillman, 516 F. Supp. 98 (N.D. Ill. 1980).

69 *See, e.g.,* Northwestern Motor Car, Inc. v. Pope, 51 Wis. 2d 292, 295, 187 N.W.2d 200, 202 (1971) ("[T]he statute contemplates that a liquidated damage clause may be enforceable if 'reasonable' [,which] is a question to be determined after trial.").

70 *See, e.g.,* Brecher v. Laiken, 430 F. Supp. 103, 106 (S.D.N.Y. 1977) (damage at the time of contracting must be incapable of estimation); Carolinas Cotton Growers Ass'n v. Arnette, 371 F. Supp. 65, 72 (D.S.C. 1974) (liquidated damages clause valid without proof of damage actually sustained).

evaluation.[71]

IV
THE RESTATEMENT (SECOND) OF CONTRACTS

A. *The Test*

Section 356 of the *Restatement Second* reads:

> Damages for breach by either party may be liquidated in the agreement but only at an amount that is reasonable in light of the anticipated or actual loss caused by the breach and the difficulties of proof of loss. A term fixing unreasonably large liquidated damages is unenforceable on grounds of public policy as a penalty.[72]

The *Restatement Second,* but for a few insignificant semantic differences, closely parallels the language of the UCC.[73] The Comments and Illustrations accompanying section 356, however, should eliminate many of the interpretive problems that have plagued UCC section 2-718(1).[74]

The *Restatement Second* test is two-fold: the liquidated damages amount must be reasonable both "in light of the anticipated or actual loss" and in light of the "difficulties of proof of loss." The *Restatement Second* definitively interprets the first stage of the UCC reasonableness test as an either-or proposition: the amount of damage fixed by the clause must be either a reasonable forecast of possible damage, or the amount must be reasonable in relation to the actual harm.[75]

The second prong of the *Restatement Second* test requires that the amount specified as liquidated damages in the contract be reasonable in light of the "difficulties of proof of loss."[76] A time orientation for this test is absent in the language of the section. The difficulty of proof could be measured at either the time of contracting, the time of breach,

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71 *See* notes 57-64 *supra.*

72 RESTATEMENT (SECOND) OF CONTRACTS § 356(1) (1979).

73 U.C.C. § 2-718 includes the phrase "inconvenience or non-feasibility of otherwise obtaining a remedy." Because no cases have been decided on this language, the drafters of the *Restatement Second* omitted it. 56 ALI PROCEEDINGS 365 (1979); *see* note 65 and accompanying text *supra.*

74 *See* notes 55-71 and accompanying text *supra.*

75 *See* RESTATEMENT (SECOND) OF CONTRACTS § 356(1), Comment b (1979):

> Under the test stated in Subsection (1), two factors combine in determining whether an amount of money fixed as damages is so unreasonably large as to be a penalty. The first factor is the anticipated or actual loss caused by the breach. The amount fixed is reasonable to the extent that it approximates the actual loss that has resulted from the particular breach, even though it may not approximate the loss that might have been anticipated under other possible breaches. See Illustration 2. Furthermore, the amount fixed is reasonable to the extent that it approximates the loss anticipated at the time of the making of the contract, even though it may not approximate the actual loss. See Illustration 3. . . .

76 RESTATEMENT (SECOND) OF CONTRACTS § 356(1) (1979).

or the time of trial.[77] The Illustrations, however, signal a change from the old rule of considering the "difficulty of proof of loss" from the perspective of the making of the contract. The *Restatement Second,* unlike the UCC, clearly indicates that the time of trial is the new vantage-point for assessing proof of loss.[78]

These two parts of the *Restatement Second* test are meant to be considered together. The Comment suggests a balancing approach: if the difficulty of proof of loss is great, the greater may be the discrepancy between the contracted sum and the actual damage.[79] Although the Illustrations are meant to demonstrate how the different parts of the test work, their language makes it clear that both prongs must be satisfied to validate a clause.

The Illustrations of the last sentence of section 356 also expressly allow a defense of no actual damages if the liquidated damage sum at the time of trial is "unreasonably" large.[80] This position conflicts with that of the first *Restatement,* which expressly denied a defense of no actual damages.[81] For example, Illustration 4,[82] and the first *Restatement's* Illustration 7,[83] reach contrary results. Under Illustration 4, *A* contracts with *B* to build a grandstand for *B's* race track by a certain day, and agrees to pay *B* $1,000 per day for each day's delay. If *B* cannot obtain

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77 For a striking example of the differences between evaluating the proof problem as of the time of breach or the time of contracting, compare the majority and minority opinions in Truck Rent-a-Center, Inc. v. Puritan Farms Inc., 51 A.D.2d 786, 380 N.Y.S.2d 37 (1976).

78 Illustrations 3 and 4 of the *Restatement Second* § 356(1) are both based on a contract to build a grandstand. In Illustration 3, "the actual loss to B is difficult to prove," and so the clause is upheld. In Illustration 4, "it is certain" that *A* has suffered no loss at all. The only difference between Illustrations 3 and 4 is an event occurring after the breach and before the trial. This event, *B*'s delay in obtaining permission to run the track, invalidates the clause because actual loss "is not difficult to prove." The only time in the sequence of facts when the result of no actual damage could be ascertained is the time of trial. This marks a departure from previous case law, *see* notes 46-48 and accompanying text *supra,* when the vantage point had been either the time contracting, or the time of breach.

79 The second factor is the difficulty of proof of loss. The greater the difficulty either of proving that loss has occurred or of establishing its amount with the requisite certainty (see § 351), the easier it is to show that the amount fixed is reasonable. To the extent that there is uncertainty as to the harm, the estimate of the court or jury may not accord with the principle of compensation any more than does the advance estimate of the parties. A determination whether the amount fixed is a penalty turns on a combination of these two factors. If the difficulty of proof of loss is great, considerable latitude is allowed in the approximation of anticipated or actual harm. If, on the other hand, the difficulty of proof of loss is slight, less latitude is allowed in that approximation.

RESTATEMENT (SECOND) OF CONTRACTS § 356(1), Comment b (1979).

80 *Id.*: "If, to take an extreme case, it is clear that no loss at all has occurred, a provision fixing a substantial sum as damages is unenforceable. See Illustration 4."

81 RESTATEMENT OF CONTRACTS § 339(1), Illustration 7 (1932); *see* notes 48, 58-59 and accompanying text *supra.*

82 RESTATEMENT (SECOND) OF CONTRACTS § 356(1), Illustration 4 (1979).

83 RESTATEMENT OF CONTRACTS § 339(1), Illustration 3 (1932).

permission to open his track for a month, *A*'s ten-day delay will cause *B* no damages at all.

On these facts, the first *Restatement* concluded that "evidence that B could not have used the grandstand for spectators during the period of delay is not sufficient to show that the delay caused no injury or that the harm is incapable of accurate estimation."[84] Illustration 4 of the *Restatement Second,* however, concludes that "since the actual loss to B is not difficult to prove, A's promise is a term providing for a penalty and is unenforceable on grounds of public policy."[85]

The *Restatement Second*'s actual-damage test requires a more careful examination of the facts of each individual case than did the first *Restatement.* The defendant may raise no actual damages as a defense and attempt to void a clause which, at the time the contract was signed, was a reasonable estimate of possible damage. Even though the parties may have fully intended to be bound by the clause at the time of contracting, the *Restatement Second* will provide relief from the bargain if no actual damage occurs.

B. *Analysis and Recommendations*

The *Restatement Second* adopted the language of the UCC, a statutory law, and appended a case-law background. Because few cases have been decided under the UCC liquidated damage provision,[86] the drafters of the *Restatement Second* faced a difficult theoretical problem:[87] Although the purpose of Restatements is to distill established principles from existing court decisions,[88] such decisions were absent. Significantly, none of the cases cited in the Reporter's Note and Comments explaining the *Restatement Second* test mention the UCC. The drafters organized this material, however, to give the appearance that their interpretation of the UCC is solidly grounded in the common law.[89] In

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84 *Id.*

85 RESTATEMENT (SECOND) OF CONTRACTS § 356, Illustration 4 (1979).

86 *See* notes 67-69 and accompanying text *supra.*

87 One of the problems that has been more acute here than in some of the other chapters is the problem of what to do with respect to the Uniform Commercial Code provisions in the area in question. It seemed inappropriate to give any substantial number of Illustrations to rules that are stated in the Code, lest we seem to be attempting to put a gloss on and interpret the Code, which is not our function.

56 ALI PROCEEDINGS 303 (1979) (remarks of Professor Farnwsorth).

88 The Introduction to the first *Restatement* revealed the original purpose of a restatement: "The function of the courts is to decide the controversies brought before them. The function of the Institute is to state clearly and precisely in the light of the decisions the principles and rules of the common law." RESTATEMENT OF CONTRACTS, Introduction, at xi (1932).

89 For example, the Reporter's Note explains that Illustration 3 is based on United States v. Bethlehem Steel Co., 205 U.S. 105 (1907), the venerable Supreme Court decision that enforced a liquidated damages clause when no damage resulted, on the ground that the

effect, section 356 is a vehicle to promote a particular interpretation of the UCC liquidated damage provision.[90] The section, because it is cast in the form of a restatement of the law of the courts, will carry more weight than ordinary commentary.[91]

The *Restatement Second* test, while vastly improving the law in certain instances, also poses problems. By adopting the second interpretation of UCC section 2-718(1),[92] the *Restatement Second* perpetuates one of the major problems with that interpretation. The approach validates a clause specifying a damage amount that would be unreasonable if viewed prospectively from the time of contracting, but that is reasonable at time of trial because of damage occurring after the breach. This approach will allow a party to recovcr damages that were not contemplated at the time the contract was signed.[93] Arguably, this approach is valid if limited to situations in which the damage was foreseeable at the time of contracting, but simply not contemplated by the parties. The subsequent harm from the breach must still meet the traditional contract test of foreseeability, even if a liquidated damage clause fortuitously corresponds to the unforeseen harm.

In addition, courts should reject the implication of the Illustrations

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clause was reasonable when entered into. *See* notes 20-26 and accompanying text *supra.* Although both Illustration 3 and *Bethlehem Steel* would enforce the clause, their reasons differ. In *Bethlehem Steel,* the lower court found, and the parties stipulated in the Supreme Court, that actual damage was not present. 205 U.S. at 117. In the *Restatement* Illustration, however, *Bethlehem Steel* becomes a "damages difficult to ascertain" example, and this fact upholds the clause.

The Illustration 3 recharacterization of the *Bethlehem Steel* facts attempts to give the *Restatement* defense of no actual damage a foundation in common-law decisions. Historically, a defense of no actual damage has nevcr been explicitly acknowledged. Some courts took judicial notice of the presence of damage and deemed the clause a penalty instead; others enforced the clauses. A more forthright method of handling the *Bethlehem Steel* ease would have been to distinguish it from the *Restatement Second* approach, or to reject it outright. The drafters chose the latter tactic for a number of previous eases. *See* RESTATEMENT (SECOND) OF CONTRACTS § 356, Illustration 3, Reporter's Note (1979).

In reality, the facts of *Bethlehem Steel* resemble Illustration 4, which explains that events occurring after the breach and before trial may serve as a basis for the defense of no actual damages. Illustration 4 reads:

> The facts being otherwise as stated in Illustration 3, B is delayed for a month in obtaining permission to operate his race track so that it is certain that A's delay of ten days caused him no loss at all. Since the actual loss to B is not difficult to prove, A's promise is a term providing for a penalty and is unenforceable on grounds of public policy.

RESTATEMENT (SECOND) OF CONTRACTS § 356, Illustration 4 (1979).

90 The *Restatement Second*'s "either/or" test for anticipated and actual damage parallels the second interpretation of the UCC § 2-718(1), discussed in notes 62-64 and accompanying text *supra.*

91 Farnsworth, *Ingredients in the Redaction of the Restatement (Second) of Contracts,* 81 COLUM. L. REV. 1, 5-9 (1981).

92 *See* notes 62-64 and accompanying text *supra.*

93 This raises a foreseeability of damages problem. *See* Hadley v. Baxendale, 9 Exch. 341 (1854).

that "difficulty of proof of loss" is measured at the time of trial.[94] That analysis is an overly restrictive limitation on parties' freedom of contract. In virtually all cases covered by Article II of the UCC, the formula of the contract price minus market price[95] provides a means of determining the actual damage. If applied at the time of trial, this formula would allow courts to invalidate all liquidated damages clauses on the ground that proof of loss is not difficult.[96]

Even when the damages may be capable of ascertainment at trial, the parties should be able to fix their damage exposure in advance.[97] If this amount turns out to be disproportionately larger than the actual damage, the second sentence of *Restatement Second* section 356 will void the clause as a penalty. Courts should de-emphasize the difficulty of proof of loss test in favor of evaluating the reasonableness of the sum contracted for in view of actual and anticipated damages. If at the time of contracting the parties insert a liquidated damages clause in order to control their damage exposure, no reason exists, barring fraud or coercion, to thwart this desire.

Although the Reporter for the *Restatement Second* stated that he "adhered to the principle that on the whole the trend is to validate [liquidated-damages] clauses,"[98] it is not immediately clear that section 356 will enhance parties' freedom to fix their damage exposure in advance. The explicit test of actual damages encourages case-by-case analysis of the equities of individual damage clauses. In at least one instance, this will be a vast improvement over previous rules. Common-law courts were reluctant to uphold liquidated damages clauses that specified one amount for a variety of breaches.[99] Even in cases where the breach was of sufficient magnitude to justify the use of the liquidated damages clause, the clause was invalid as a penalty. Under the *Restatement Second,* an overbroad triggering mechanism will not invalidate the clause if actual damages are proportional to the sum specified.[100] In this situation, the intent of the parties will be upheld, and sloppy drafting will not defeat the clause.

Under the *Restatement Second,* each court must ultimately decide how much actual damage will suffice to uphold a clause.[101] The text

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94 *See* notes 77-78 and accompanying text *supra.*

95 U.C.C. §§ 2-706, 2-708.

96 Comment, *supra* note 66, at 1359.

97 *See* Sun Printing & Publishing Ass'n v. Moore, 183 U.S. 642, 660 (1901) (if damages are ascertainable at trial, court should require proof of damages actually sustained; "we think the asserted doctrine is wrong in principle, was unknown to the common law, does not prevail in the courts of England at the present time and is not sanctioned by decisions of this court.").

98 56 ALI PROCEEDINGS 366 (1979).

99 Courts continue to be reluctant to uphold these clauses. *See* Bradford v. New York Times Co., 501 F.2d 51, 57 (2d Cir. 1974); C. MCCORMICK, DAMAGES § 151 (1935).

100 Illustration 2 to § 356 of the *Restatement Second* specifies this result.

101 *See, e.g., In re* Gelino's Inc., 43 F.2d 832 (E.D. Ill. 1930) (liquidated damages 40%

and commentary give no guidance in this matter. Presumably, courts will not rely on any one formula, but will consider the essential fairness of the clause in view of all the facts. Although courts should consider the actual damage, they should also understand that parties contract for liquidated damages to avoid costly litigation over damage that will be uncertain or difficult to ascertain. The parties will rarely forecast the exact amount of their damages. They contract for a liquidated damages sum, however, with the knowledge that their estimate may not be completely fair to one party. Both parties knowingly accept this risk, and consider it in the contract price.

The need for a flexible policy of allowing courts to invalidate a clause that was reasonable when made, but is disproportionate to actual losses, justifies an infringement on the parties' freedom to contract. The first *Restatement* rule did not justify invalidating such clauses to avoid injustice. The *Restatement Second* substantially reduces the need for judicial maneuvering.

CONCLUSION

Under the first *Restatement,* judges had three choices when confronted with a case of no actual damages at the time of trial: use the *Restatement* to bar evidence of actual damages and reach an inequitable result; label the clause a penalty, and by bending the rule, arrive at an equitable solution; or openly criticize the *Restatement* position.[102] The last two options yielded equitable holdings, but posed the danger of inconsistent results. Some judges followed the *Restatement* strictly; others did not. The *Restatement Second* solves this problem by giving an explicit command to invalidate clauses that may have been reasonable estimates of probable harm, but that ultimately prove disproportionate to actual damages.

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higher than actual damage held unenforceable). If the clause is seen as one limiting liability, the disproportionality may have no limit. *See* Feary v. Aaron Burglar Alarm, Inc., 32 Cal. App. 3d 553, 108 Cal. Rptr. 242 (1973); Ray Farmer's Union Elevator Co. v. Weyrauch, 238 N.W.2d 47, 50 (N.D. 1975).

102 *See* Summers, *General Equitable Principles Under Section 1-103 of the U.C.C.,* 72 NW. U.L. REV. 906, 907 (1978).