

## **Cleaning Up *Lake River***

Abstract. A casebook favorite for exploring the liquidated damage-penalty clause distinction is *Lake River v. Carborundum* in which a minimum quantity clause was found to be a penalty clause. In this paper I argue that the case was framed improperly. The contract was for the provision of a service—setting aside capacity—which was valuable to the buyer and costly to provide for the seller. The primary purpose of the minimum quantity clause was the pricing of that service. The case raises a significant damages issue: if there is an anticipatory repudiation of a contract that is take-or-pay or has a stipulated damage clause, should the promisee’s ability to mitigate be taken into account when reckoning damages.

## Cleaning Up *Lake River*

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Nearly two decades ago, Judge Richard Posner bemoaned the mismatch of the facts as presented in judicial opinions with the actual facts, and argued that this had adverse consequences for the development of doctrine.

If factual uncertainty is disproportionately characteristic of litigated cases . . . then, given the difficulty of dispelling such uncertainty by the methods of litigation, we can expect the factual recitals in published judicial opinions to be wrong much of the time. . . .

And especially in cases where there is no published dissent, judicial opinions exemplify “winners’ history.” The appellate court will usually state the facts as favorably to its conclusions as the record allows, and often more favorably. . . . The tendency I have described is abetted by the reluctance of academic commentators to expand their study of cases beyond judicial opinions. Rarely will the commentator get hold of the briefs and record to check the accuracy of the factual recitals in the opinion.

All this would be of relatively little importance were it not that lawyers’ and particularly judges’ knowledge of the world, or at least of the slice of the world relevant to legal decision making, derives to a significant degree from judicial opinions. One of the distinctive features of judges as policy makers—and it should be clear by now that judges in our system *are*, to a significant degree, policy-making officials—is that they obtain much of their knowledge of how the world works from materials that are systematically unreliable sources of information.<sup>1</sup>

His point is well illustrated by one of his own opinions, *Lake River v. Carborundum*,<sup>2</sup> a casebook favorite for demarcating the liquidated damages/penalty clause divide. The facts as presented in the opinion are misleading. Counsel’s framing of the issue obscured the essential economics of the contract. And, as a consequence, the result was wrong.

What has made the case so attractive to casebook authors was that Judge Posner was playing against type. His normal presumption would be that sophisticated businessmen should be left to their own devices; indeed, a significant portion of the opinion was devoted to urging the abandonment of the rule against penalty clauses. However, he felt constrained, both by the litigators agreement that the disputed clause was a stipulated damage clause, and by Illinois law’s preference for resolving doubtful cases in favor of classification as a penalty. “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

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<sup>1</sup> Richard A. Posner, *The Problems of Jurisprudence*, 1990, pp.210-211.

<sup>2</sup> Cite.

greatly exceeds a reasonable upper estimate of what the damages are likely to be, it is a penalty.”<sup>3</sup>

Framing the dispute in terms of the penalty clause/liquidated damages distinction was a mistake. The clause in question was not a remedy for breach—it was an integral element in defining the contractual obligation. However, the role of the clause cannot be understood without the contract language absent from the opinion. Its absence is a symptom of a bigger problem—the litigators failed to appreciate the underlying economics of the transaction and their framing of the issues reflected that.

I begin by recounting Posner’s analysis of the disputed clause, providing some of the relevant background. His argument in essence was that enforcement would dramatically over-compensate Lake River. I will show that even as he framed the case, he overstated the extent of the over-compensation. But that is really only a side issue. The more significant point is that when we take into account the remainder of the contract, the over-compensation question disappears. I will first stick to the stipulated damages framework and argue that the clause would have resulted in reasonable liquidated damages. I then turn to the more significant point, and show why the clause helped define the contractual obligation and had nothing to do with stipulated damages. Finally, I will consider a thorny doctrinal problem: if there is an anticipatory repudiation of a contract containing a stipulated damage remedy, should the promisee’s mitigation (technically, avoidance) allow the promisor to reduce its liability?

Carborundum contracted with Lake River to bag and distribute Ferro Carbo, an abrasive powder. In order to prevent possible contamination with other products, Carborundum insisted that Lake River install a new bagging system costing \$89,000 to be used exclusively for Ferro Carbo. The contract included a minimum-quantity guarantee, which the parties treated as a stipulated damages clause:

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.<sup>4</sup>

The bagging costs were about four to five percent of the value of the bagged product.<sup>5</sup> Had Carborundum taken the minimum quantity, Lake River projected that it would make a profit of 20 percent of the contract price. Because demand for Ferro Carbo declined, during the three-year term Carborundum shipped only 12,000 tons, 55% of the minimum. Had Carborundum shipped the minimum, it would have paid \$533,000. (The pricing formula was in a separate

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<sup>3</sup> pp. 1289-1290.

<sup>4</sup> Cite.

<sup>5</sup> The price for Lake River’s services turned out to be about \$23 per ton (\$533,000/22,500). Lake River, as self-help, attempted (unsuccessfully) to keep 500 tons valued at \$269,000. The unit price, therefore, was \$538 per ton.

schedule that was not reproduced in the briefs.) Carborundum actually paid \$292,000 leaving a shortfall of \$241,000, which Lake River argued it was entitled to as liquidated damages

Although Judge Posner did not believe the rule against enforcement of penalty clauses made sense when dealing with agreements negotiated by sophisticated business parties,<sup>6</sup> he felt bound by Illinois law. With his interpretation of the contract, the liquidated damages always exceeded the upper estimate, hence his conclusion that this was an unenforceable penalty clause. He began by asking what would happen if Carborundum breached on the first day. His answer: Carborundum would owe \$533,000; Lake River's costs would have been only \$89,000 and its profit would therefore be the difference,  $\$533,000 - \$89,000 = \$444,000$ . That, he argued would be a substantial windfall compared to the earnings Lake River should have expected had Carborundum performed (20% of \$533,000, or \$107,000). He then made various calculations of Lake River's profit for various quantities short of the 22,500 ton minimum. The expected cost at the minimum quantity was the \$533,000 less the 20% profit. He then assumed that the only fixed cost was the bagging system and that the variable costs were roughly proportional to the quantity.<sup>7</sup> So, for the actual output of 55%, Lake River's expected profit would be \$19,000 for the service provided plus \$241,000 in damages—over twice its expected profit had Carborundum performed. For all quantities below the minimum, Lake River's net would exceed the profits had there been no breach. Moreover, he pointed out, his calculations assumed that the bagging system had no value apart from the contract. If it had some value, he noted, the numbers would get even worse.

Before turning to the contract itself, I should point out that this calculation exaggerates the discrepancy. Distinguishing fixed and variable costs can be problematic, but it is safe to say that the bagging system was not the only fixed cost. Unless the 20% profit was meant to be the payment for all the other fixed factors (management salaries, the building, the warehouse, etc), fixed costs over the life of the contract were undoubtedly higher. One obvious variable cost was the bagging material, but responsibility for that was assigned to Carborundum. (Clause 3) Still, if Lake River were guaranteed \$533,000 regardless of the quantity bagged, then, for any quantity below the minimum, Lake River would do better than if it had produced the minimum. So, if we take the Illinois penalty clause language literally, the minimum must always result in a compensatory payment in excess of Lake River's damages and it should lose. The numerical example, right or wrong, adds nothing, save an exclamation point.

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<sup>6</sup> Lake River attempted to downplay the legal sophistication of its negotiator: "The minimum guarantee provision was not inserted as a determination of the legal damages Lake River would incur as a result of a breach by Carborundum, since Passerelli, who negotiated the agreement was unfamiliar with the concept of legal damages." (Lake River Brief, p, 11) I don't know why counsel didn't expand on this argument and claim that, indeed, the clause was not a stipulated damage clause.

<sup>7</sup> With these assumptions, the variable costs at the minimum output would have been  $\$533,000 - \$107,000 - \$89,000 = \$337,000$ . Average variable costs would have been  $\$337,000 / 22,500 = \$15$  and the contract price would have been  $\$533,000 / 22,500 = \$23.70$ . Only 12,000 tons were bagged for which Lake River received  $\$23.70 \times 12,000 = \$284,400$ . Variable costs were  $\$15 \times 12,000 = \$180,000$ . Profits would have been revenue minus variable costs minus fixed costs, or  $\$284,400 - \$180,000 - \$89,000 = \$15,000$ . This number differs slightly from his because of differences in rounding.

The problem with the analysis is not, therefore, the distinction between fixed and variable costs. The problem is focusing on the clause in isolation, without considering the structure of the entire agreement. Two clauses are of particular importance. The two clauses provide the context that was lacking in the written opinion. Without them it is hard to understand why Carborundum would agree to a minimum.

1. Scope of Agreement. From time to time during the term of this Agreement, CARBORUNDUM shall ship to LAKE-RIVER's packaging plant located at Berwyn, Illinois, quantities of CARBORUNDUM's product known as "Ferro Carbo" (called "Product"). CARBORUNDUM agrees to purchase from LAKE-RIVER and LAKE-RIVER agrees to furnish to CARBORUNDUM all terminal services necessary for the orderly conduct of CARBORUNDUM's business in the marketing and distribution of the product.

2. c. Shipping. LAKE-RIVER shall load and ship the bagged product for CARBORUNDUM's account and according to CARBORUNDUM's shipping instructions. For scheduling purposes, LAKE-RIVER shall not be required to bag more than four hundred (400) tons of product each week. LAKE-RIVER shall ship bagged product from storage or from current production by trucks or box cars as CARBORUNDUM shall direct. Trucks and box cars shall be loaded in accordance with instructions issued by CARBORUNDUM. Sufficient dunnage shall be furnished by LAKE-RIVER for CARBORUNDUM's account to properly protect bagged product in transit. Shipping documents shall be prepared and distributed by LAKE-RIVER as directed by CARBORUNDUM.<sup>8</sup>

Consider first clause 2. c. Buried in the middle of a paragraph about shipping instructions is the only explicit contractual constraint on Carborundum's claim for Lake River's services. It could not ask Lake River to bag more than 400 tons in any week. So, had Carborundum shipped the maximum each week it would have had bagged over 60,000 tons--about three times the contract minimum. However, the contract language itself is not entirely consistent with the parties' description of the contract. Lake River's brief, for example notes that Lake River should have the capacity to bag 10,000 tons per year, roughly half the contractual maximum and one-third greater than the contractual minimum.<sup>9</sup> To make matters worse, Lake River overstated Carborundum's flexibility, arguing that Lake River faced "complete uncertainty as to when Carborundum would ship the Product for bagging."<sup>10</sup> I have no idea why Lake River's counsel ignored the one contract term that did put an explicit outer bound on Carborundum's flexibility. Nor do I know why the maximum obligation was located in the middle of a clause dealing with other, largely mechanical, matters.

Returning to clause 1, what is it that Carborundum promised to do? This was neither a full-output nor a requirements contract; Carborundum only said that it would deliver Ferro Carbo "from time to time." The contract was for two things. First, Lake River would bag and distribute

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<sup>8</sup> Appendix to Lake River Brief.

<sup>9</sup> Lake River Brief, p. 9.

<sup>10</sup> Lake River Reply Brief, p. 5.

some product if Carborundum delivered it. However, Carborundum did not promise to deliver any product. The second thing that Lake River promised was that it would stand ready to bag a certain amount of Ferro Carbo, and it would stand ready for three years. Carborundum remained free to buy bagging and distribution services from anyone. Carborundum's option is the crucial feature of the contract. If for any reason Carborundum decided not to send product to Lake River, it wouldn't have to. If, for example, the price others charge were to fall below the contract price, it would be free to go with them; if it was above the contract price, it would use Lake River. "From time to time" does not bind Carborundum. Absent the minimum quantity clause there would be no consideration and, therefore, no contract.

Posner characterized the contract as still being executory: "Lake River was the victim of a breach of a portion of the contract that remained entirely unexecuted on either side. Carborundum had not shipped the other 10,500 tons, as promised; but on the other hand Lake River had not had to bag those 10,500 tons, as it had promised."<sup>11</sup> But, as Lake River's counsel asserted, Lake River had fully performed. For three years it had stood ready to bag up to 400 tons of Ferro per week. "Carborundum's argument that Lake River incurred no expenses as a *result* of the breach ignores the reality that Lake River's expenses as required by the Agreement, were all incurred *before* the breach—which occurred at the end of the Agreement's term on September 1, 1982." (Lake River Reply Brief, p. 10, emphasis in original) Counsel seems to imply that the breach was a failure to take the minimum quantity. The alternative version is that the only breach was Carborundum's failure to pay.

If we view the suspect clause as one stipulating damages, the expected damages are not the ones Judge Posner recognized. As Lake River noted, "the *quid pro quo* Lake River received for giving Carborundum control over the timing of product shipments was a guaranteed minimum amount of revenue."<sup>12</sup> The district court and Lake River emphasized the uncertainty of the revenue stream as a justification for the minimum. But the timing itself is not the problem. In order to afford Carborundum flexibility in determining the tonnage to be bagged, Lake River had to incur costs (explicit or otherwise) in addition to the bagging machine costs mentioned in the contract and in Judge Posner's opinion. To stand ready to perform, Lake River might have to maintain a larger facility or labor force than otherwise; or it might have to maintain sufficient capacity to remain ready to meet this obligation; or it might have to forego an attractive alternative. Lake River did make this point:

Under the Agreement, Lake River was required to spend more than \$89,000 to purchase bagging equipment, was required to set up a brand new bagging operation to be used exclusively for Carborundum's Product, and was required to incur all of the fixed costs associated with setting aside the necessary space (including plant depreciation, corporate overhead, taxes, and utilities such as light and heat). Lake River was also required to have sufficient manpower available to run the bagging operation, but could not efficiently allocate such

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<sup>11</sup> P. 1287.

<sup>12</sup> Reply Brief, p. 7.

manpower between the Carborundum project and its other projects in light of the uncertainty over the timing of product shipments by Carborundum.<sup>13</sup>

If we treat the minimum quantity as stipulated damages, with this understanding of the contract it should be clear that damage estimation would be extremely difficult *ex ante* and measurement would be extremely difficult *ex post*. For example, determining what opportunities were foregone (or, *ex ante*, could have been foregone) by Lake River because it had to stand ready to bag 400 tons per week for a fixed price schedule would be a complex (if not futile) exercise. The clause should certainly meet the Illinois criterion concerning “the likely difficulty of measuring actual damages.” So, even if we treat the minimum quantity clause as subject to the penalty clause bar, a better understanding of the contract would make the liquidated damages characterization more plausible.

However, it should not be treated as a damage measure at all. Nothing is gained by characterizing the minimum quantity clause as a remedy for breach when the only breach was Carborundum’s failure to pay. We do not know what was in the minds of the contracting parties. The best evidence we have is the written document. It may have been poorly drafted, but, however inartful the language, the obligations of both parties were clear. Lake River fully performed its obligation, providing a valuable service by standing ready to bag Carborundum’s product. They also serve who only stand and wait. The minimum quantity/minimum payment served two functions in addition to providing consideration. First, given that Carborundum would have been free to take its business to a lower-cost provider during the three years, the minimum payment drastically reduced the incentive to do so. In effect the clause set the price on the first 22,500 tons at \$0. Only for quantities greater than the minimum would Carborundum find shopping possibly profitable.

Second, it priced the service Lake River provided. Carborundum paid for three years worth of access to Lake River’s bagging facilities at a predetermined pricing formula and that is what it received. The price of that flexibility has nothing to do with damage estimates. The flexibility had value to Carborundum and it was costly to provide for Lake River. The price, like that for other services, would fall somewhere between the expected value to the former and the expected cost of the latter. Perhaps Carborundum paid too much for the flexibility; but there is no reason to second-guess the consideration paid for provision of a valuable service.

Judge Posner attempted to distinguish this contract from a take-or-pay agreement, which, he claimed, would not constitute a penalty. The distinction is an artificial one since functionally the clause performs the same role. The party with discretion has to pay the opposite party for the costs it could incur by affording that discretion.<sup>14</sup> Both set a non-linear pricing formula: a fixed price independent of usage, a zero marginal price up to the minimum, and a positive marginal price thereafter. The doctrinal response has been to treat the minimum in a take-or-pay contract as an “alternate contract,”<sup>15</sup> a roundabout way of sometimes getting to the right result. For a

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<sup>13</sup> Reply Brief, p. 6.

<sup>14</sup> For further analysis of take-or-pay contracts, see Goldberg, *Framing Contract Law* (2006), ch. 5. Pay-or-play clauses perform the same role in movie contracts, see *Id.*, ch. 15.

<sup>15</sup> See Corbin. *Etc.*

long-term coal supply contract the supplier's costs of developing and dedicating capacity might be easier to observe than in this contract, but that should not obscure the essential similarity. Nor should doctrinal boxes obscure the essential economics of the transaction.

The contract, as I noted above, was fully performed by Lake River. But what if the contract were in fact breached prior to the end of the three-year period? Recall that in Judge Posner's hypothetical the contract was breached on the first day. There is a fundamental difference between the case in which the three-year term had expired (no breach) and one in which one party repudiated prior to expiration. How should we treat an anticipatory repudiation or the premature total breach of a long-term contract? The major difference is that once the contract is recognized as abandoned, Lake River's resources would be freed up. Carborundum should still be responsible for paying for the minimum quantity; it had breached its promise to pay. However, the damages should be offset by the value of the resources freed up by the termination.

Indeed, according to Judge Posner "Lake River argues that it would never get as much as the formula suggests, because it would be required to mitigate its damages."<sup>16</sup> I assume that this was raised in oral argument, because it was not in the briefs. He rejected this argument because, he claimed, it would undercut the virtues of liquidated damages; but, if Lake River's counsel was responding to the premature breach scenario, it would be a sensible response. If Lake River no longer had to assure that it could bag 400 tons per week, it could have used its capacity for other purposes. So, while, Carborundum would still be responsible for the minimum payment, in the event of an anticipatory repudiation, the law *might* require it to offset against that payment revenues received from utilizing the freed up capacity elsewhere.

I said *might* in the previous paragraph advisedly since the law regarding damages for the anticipatory repudiation of a long-term contract is a bit of a mess. Even if it is a contract for goods falling squarely in the take-or-pay/alternative performance box, courts struggle with the problem; see, for example, *Tractebel Energy Mktg. v. AEP Power Mktg.*<sup>17</sup> and *Roye Realty & Developing, Inc. v. Arkla, Inc.*<sup>18</sup> The problem is compounded when the contract is for a service (like bagging); contract law has been somewhat less inclined to offset in "to do" contracts, the reason being that it could have been possible to do the additional work while still performing the contract.<sup>19</sup> Regardless, the mitigation principal should remain valid, although its implementation might turn out to be complicated.

The problem is further compounded if the disputed clause is characterized as being for stipulated damages. As a matter of sound economics and policy, there should be no difference. However, if the stipulated damage remedy is viewed as exclusive, one could argue that there should be no offset following an anticipatory repudiation. Judge Posner has taken that position in private correspondence. I do not believe that the law requires identical treatment of a breach

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<sup>16</sup> P. 1291.

<sup>17</sup> 2005 U.S. Dist. LEXIS 15972 (S.D.N.Y. 2005).

<sup>18</sup> 863 P.2d 1150 (1993).

<sup>19</sup> See Farnsworth §12.12.

and an anticipatory repudiation, but I am content to leave it as a recommendation: in the event of an anticipatory repudiation, the law should offset the promisee's benefits against the stipulated damages.

The preceding suggests five conclusions. First, what was at stake in this contract was the provision of a service—setting aside capacity—which was valuable to the buyer and costly to provide for the seller. The primary purpose of the minimum quantity clause was to price that service, not to define a remedy. Second, even if a court did somehow choose to read the clause as a stipulated remedy, the difficulty of measuring the costs incurred by setting aside capacity would have made the clause a plausible liquidation of damages. Third, the doctrinal boxes led to the obscuring of the simple economics of the transaction. Absent an economic framework, the litigators could not make the argument cleanly, although bits and pieces of it did appear in their briefs. Fourth, there is a big difference between a failure to hit a minimum target in a completed contract and a premature breach of that contract. The way the parties framed the issues blurred that distinction. Finally, while we cannot generalize from a single data point, this analysis provides one more bit of ammunition against the penalty clause bar for contracts between sophisticated parties.