2008

Cleaning Up Lake River

Victor P. Goldberg
Columbia Law School, vpg@law.columbia.edu

VIRGINIA LAW & BUSINESS REVIEW

VOLUME 3 | FALL 2008 | NUMBER 2

CLEANING UP LAKE RIVER

Victor P. Goldberg†

† Jerome Greene Professor of Transactional Studies and Co-director, Center for Law and Economic Studies.

ABSTRACT

A casebook favorite for exploring the liquidated damage/penalty clause distinction is *Lake River Corp. v. Carborundum Co.* in which Judge Posner found a minimum quantity clause to be an unenforceable penalty clause. In this paper I argue that the case was framed improperly. Had the litigators recognized that the contract afforded one party an option, the result should have been different. The contract was for the provision of a service—setting aside capacity—which was valuable to the buyer and costly for the seller to provide. The primary purpose of the minimum quantity clause was the pricing of that service. The case indirectly raised 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?

INTRODUCTION

IN my recent book, *Framing Contract Law*,[1] I argued that litigators and judges often fail to understand the economics of transactions and that this failure has implications both for interpreting a particular contract and for doctrine itself. I illustrated that point by reexamining a number of significant contract cases, many of them casebook staples. This paper provides one more piece of evidence for the value of the enterprise by analyzing another casebook favorite, *Lake River Corp. v. Carborundum Co.*[2] The example is particularly compelling because the judge in this case was Richard Posner, one of the most sophisticated practitioners of law and economics.

The litigators framed the case in terms of the liquidated damages/penalty clause distinction. If a stipulated damage remedy in the agreement could be characterized as liquidated damages it would be enforceable. But if a court found it to be a penalty, it would not. A lot of scholarly writing, including that of Judge Posner, has questioned the logic behind the penalty clause bar in

1. VICTOR P. GOLDBERG, FRAMING CONTRACT LAW (2006).
2. 769 F.2d 1284 (7th Cir. 1985). The casebooks that rely on this case include, see, e.g. JOHN D. CALAMARI, JOSEPH M. PERILLO & HELEN HADJIYANNAKIS BENDER, CASES AND PROBLEMS ON CONTRACTS, 741-43 (5th ed. 2007); 1 STEWART MACAULAY, JOHN KIDWELL & WILLIAM WHITFORD, CONTRACTS: LAW IN ACTION 90-96 (2d ed. 2003); ARTHUR ROSETT & DANIEL J. BUSSEL, CONTRACT LAW AND ITS APPLICATION, 226-32 (6th ed. 1999); ROBERT E. SCOTT & JODY S. KRAUS, CONTRACT LAW AND THEORY 980-87 (4th ed. 2007).

contracts between sophisticated parties.[3] Nevertheless, the doctrine has survived. Indeed, in some states, notably Illinois, there is a presumption in favor of finding a disputed clause to be an unenforceable penalty.

In *Lake River*, the defendant, Carborundum Corporation ("Carborundum"), had agreed to pay for a minimum quantity over three years, but only took about half of the agreed upon amount. The plaintiff, Lake River Company ("Lake River"), argued that the minimum was a liquidated damage clause and should be honored. The defendant claimed that enforcing the clause would yield an award in excess of actual damages and therefore, the clause should be treated as a penalty.[4] Judge Posner, despite his hostility to the penalty clause bar, accepted the defendant's version and threw out the disputed clause.[5] In personal correspondence, Judge Posner said that he was bound by the parties' framing of the issue.[6] My purpose is not to apportion responsibility. Rather, it is to demonstrate the power of the economic approach.

Properly understood, the language in question was neither a penalty nor a liquidated damage clause. That question should never have arisen. The contract gave the buyer considerable discretion as to when and how much it would use the seller's services. By granting the buyer flexibility, the seller provided a valuable service and incurred some costs in providing that service. The minimum quantity clause was a key factor in defining the obligation and in pricing the service. Even if one were to cling to the stipulated damages framework, the analysis would demonstrate that the stipulated damages were not necessarily excessive. Given the proper understanding, a reasonable court could easily have found a valid liquidated damage cause. Of course, a single case study cannot show that the doctrine is wrong, but the debunking of a famous decision is at least a step in that direction.

While I am arguing that the litigators did not understand the economics of the transaction, I do not mean to suggest that things would have been fine

---

3. RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 128-31 (6th ed. 2003). *See also* Ugo Mattei, *The Comparative Law and Economics of Penalty Clauses in Contracts*, 43 AM. J. COMP. L. 427, 428-30 (1995); Paul H. Rubin, *Unenforceable Contracts: Penalty Clauses and Specific Performance*, 10 J. LEGAL STUD. 237, 246 (1981) (finding ultimately that the penalty clause bar might be an efficient rule); Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 YALE L.J. 541, 616-17 (2003); Alan Schwartz, *The Myth That Promisees Prefer Supracompensatory Remedies: An Analysis of Contracting for Damage Measures*, 100 YALE L.J. 369, 370 (1990).
4. *Lake River Corp.*, 769 F.2d at 1286.
5. *Id.* at 1290.
6. E-mail from Hon. Richard A. Posner, Judge, Seventh Circuit Court of Appeals, to author (Feb. 18, 2007) (on file with the Virginia Law & Business Review).

had they only asked the transactional lawyers or the principals themselves. The deal participants also might have had no idea why they structured the transaction as they did, or they might not have been capable of articulating their reasons. To take an example from antitrust law, parties were using vertical restrictions (exclusive dealing, exclusive territories, resale price maintenance, etc.) long before a coherent economic rationale was developed. My approach is to use economic reasoning to understand why reasonable business people would structure their affairs in a particular manner, not to focus on the explanation that the parties give.[7]

Nearly two decades ago, Judge 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.
>
> . . . 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.[8]

His point is well-illustrated by *Lake River*. The facts as presented in the opinion are misleading. The role of the suspect clause cannot be understood without other contract language absent from the opinion. Its absence is a

7. For a bit more on this standard, see GOLDBERG, *supra* note 1, at 378-79.
8. RICHARD A. POSNER, THE PROBLEMS OF JURISPRUDENCE 210-11 (1990).

symptom of the problem—the litigators failed to appreciate the underlying economics of the transaction and their framing of the issues reflected that.

In Part I, I will summarize the trial judge's opinion and the arguments made in the respective parties' briefs. In Part II, I will present Judge Posner's opinion. His argument, which largely tracks Carborundum's, was that enforcement would dramatically over-compensate Lake River, and, therefore, the minimum clause would be an unenforceable penalty. In Part III, I will introduce two clauses in the contract that were ignored by all the participants, but which put the suspect clause in perspective. I will then show how, if the issue had been properly framed, the over-compensation question disappears. I will first show why the clause helped define the contractual obligation and had nothing to do with stipulated damages. I will then show that even if the clause were viewed as defining stipulated damages, the estimate would have been reasonable (or at least not unreasonable); it should fall in the liquidated damages category. Finally, I will consider a thorny doctrinal problem, raised only obliquely in *Lake River*: if there is an anticipatory repudiation of a contract containing a stipulated damage remedy or a minimum quantity, should the promisee's mitigation (technically, avoidance) be taken into account in assessing the promissor's liability?

I. THE CASE PRE-POSNER

The story as recounted in the briefs and the opinions is a simple one. Carborundum entered into a three-year contract with Lake River which would 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.[9] The clause in controversy (Paragraph 4) was a minimum-quantity guarantee:

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

9. *Lake River Corp.*, 769 F.2d at 1286. All numbers have been rounded to the nearest thousand. *Id.* at 1287.

> at the then prevailing rates for the difference between the quantity bagged and the minimum guaranteed.[10]

Because the demand for Ferro Carbo had declined, Carborundum only bagged about 12,000 tons in the three years, 55% of the minimum. The costs of Lake River's services were only about four to five percent of the value of the bagged product.[11] Had Carborundum shipped the minimum, it would have paid $533,000.[12] Carborundum actually paid $292,000 leaving a shortfall of $241,000, which Lake River argued it was entitled to as liquidated damages. Carborundum refused, precipitating the litigation. To assure payment, Lake River engaged in self-help, asserting a lien over 500 tons of Ferro Carbo in its possession.[13] Both the trial judge and Judge Posner found that it was not entitled to assert that lien;[14] that issue need not concern us.

The trial judge found that the purpose of Paragraph 4 was to stipulate damages and that it passed muster:

> Paragraph 4 of the contract was inserted in order to estimate damages which would be sustained by Lake River in the event the contract was not fulfilled. In other words, paragraph 4 was in the contract as an attempt by Lake River to assure a certain return on its investment in the special equipment to be purchased, and Carborundum knew this.[15]

The clause was valid, the court argued, because

> At the time that the parties entered into the Agreement, the amount of injury which would be suffered by Lake River in the event of a breach by Carborundum was uncertain in amount and difficult to measure, given the unpredictability of the timing or amounts of shipments of product by Carborundum to Lake River, and the inability to predict with any degree of accuracy

10. *Id.* at 1286.
11. *Id.* The price for Lake River's services turned out to be about $24 per ton ($533,000/22,500). Lake River, as self-help, attempted (unsuccessfully) to keep 500 tons valued at $269,000. *Id.* The market unit price, therefore, was $538 per ton ($269,000/500), making Lake River's services 4-5% of the market price. ($24/$538).
12. *Id.* The pricing formula was in a separate schedule that was not reproduced in the briefs.
13. *Id.*
14. *Id.* at 1288.
15. Lake River Corp. v. Carborundum Co., No. 82 C 6292, slip op. at 4 (N.D. Ill. filed Mar. 15, 1984), *aff'd in part, rev'd in part*, 769 F.2d 1284 (7th Cir. 1985).

> the flow of revenue under the contract. The minimum quantity agreed to between the parties was not unrealistic or unreasonably large.[16]

These findings were designed to satisfy the Illinois standard which Judge Posner characterized in this way:

> To be valid under Illinois law a liquidation of damages must be a reasonable estimate at the time of contracting of the likely damages from breach, and the need for estimation at that time must be shown by reference to the likely difficulty of measuring the actual damages from a breach of contract after the breach occurs. If damages would be easy to determine then, or if the estimate greatly exceeds a reasonable upper estimate of what the damages are likely to be, it is a penalty.[17]

In their briefs, both parties accepted the framing of the question as the proper characterization of the stipulated damages.[18] Carborundum's argument that the clause was an unenforceable penalty had two prongs. First, it used the testimony of Lake River's contract negotiator, James Passerelli, to show that Lake River did not intend to provide a reasonable estimate of damages—indeed, it was entirely unconcerned with damage measurement. Second, it argued that application of the clause in certain contexts would be punitive because it would result in an assessment far exceeding actual damages.[19]

Passerelli's testimony was characterized, not entirely accurately, as follows: "In fact, Passerelli testified that Lake River's <u>sole purpose</u> for inserting the provision in the contract was to <u>force</u> Carborundum to perform the agreement."[20] Passerelli's actual testimony reads as follows:

> QUESTION: When you put the minimum quantity provision in the contract you were merely trying to assure a return on investment and you were not attempting to estimate

16. Lake River Corp. v. Carborundum Co., No. 82 C 6292, slip op. at 4 (N.D. Ill. filed Mar. 15, 1984), *aff'd in part, rev'd in part*, 769 F.2d 1284 (7th Cir. 1985).
17. *Lake River Corp.*, 769 F.2d at 1289-90.
18. Reply and Responsive Brief of Appellant and Cross-Appellee at 4, *Lake River Corp.*, 769 F.2d 1284 (Nos. 84-1623, 84-1688) [hereinafter Lake River Reply Brief]; Brief of Defendant-Appellee and Cross-Appellant at 11, *Lake River Corp.*, 769 F.2d 1284 (Nos. 84-1623, 84-1688) [hereinafter Carborundum Brief].
19. Carborundum Brief, *supra* note 18, at 13, 17.
20. *Id.* at 14.

> the damages that Lake River would sustain if Carborundum breached the contract, were you?
>
> ANSWER: That's correct.
>
> * * * *
>
> QUESTION: Indeed what you wanted to do was to assure that either Carborundum would go through and perform the contract as it had agreed or that Carborundum would be forced to pay Lake River as if it had gone through with the contract?
>
> ANSWER: That's correct.
>
> QUESTION: Indeed, what you provided in the contract was that if Carborundum breached the contract it would have to pay 100 percent of the amount that it would have paid if it had gone through with the contract, isn't that correct?
>
> ANSWER: I believe that is correct, yes.[21]

The testimony did not say anything about "forcing" Carborundum to *perform*; it was only forced to *pay*. It did, however, suggest that the purpose of the clause was unrelated to any damage projections. This led Carborundum to point out that "by Lake River's own admission, Paragraph 4 was not inserted to provide a fair estimate of damages to be paid as an alternative to performance."[22] Lake River's response to this was a rather lame attempt to downplay Passerelli's legal sophistication: "[t]he 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."[23] Ignorance is not much of a defense, especially when the agreement was negotiated by a senior employee and signed by the president. Lake River was trapped by the framing of the issue as penalty versus liquidated damages. Otherwise, it could have turned the testimony to its advantage by agreeing that it had not intended that the clause be related to damages, but that it had another purpose entirely.

Second, Carborundum argued that enforcement of the clause would, in certain circumstances, result in overcompensation. It began with a *reductio ad absurdum*:

21. *Id.* at 13-15.
22. *Id.* at 15.
23. Brief of Appellant and Cross-Appellee at 11, *Lake River Corp.*, 769 F.2d 1284 (Nos. 84-1623, 84-1688) [hereinafter Lake River Brief].

> [I]f Carborundum had not delivered one pound of the Product, pursuant to the literal terms of Paragraph 4, Lake River could bill Carborundum $533,700.00. Simple mathematics reveals that Lake River would have received an almost 600 percent return on its $89,404.00 investment for equipment that has a useful life beyond the term of the Agreement. It is patent that there is absolutely no relationship between the amount of damages that could be estimated at the inception of the Agreement and the amount provided in Paragraph 4.[24]

It went on to argue that Lake River had underestimated costs so that, if there had there been full performance, Lake River would have lost money. An award of $241,000 would, therefore, have given Lake River a large windfall.[25] Lake River conceded that it had underestimated costs, but claimed that it still would have made a modest profit had Carborundum fully performed.[26] The trial court found that if Carborundum had delivered the contract minimum "Lake River still may not have made a profit on the contract."[27] The accuracy of the profit projections doesn't matter for our purposes and the issue did not surface in Posner's opinion. If it had mattered, he surely would have been justified in accepting the trial court's finding as not clearly erroneous.

I will argue in Part III that the economic rationale for Paragraph 4 was that it was meant to constrain Carborundum's discretion regarding its use of Lake River's facilities. Lake River did at least hint at an argument of this sort:

> [T]he Agreement was structured so that Lake River would have to stand ready to perform throughout the Agreement's term, even though Carborundum's actual shipments might be considerably reduced. Under the circumstances of reduced shipments, such as actually occurred here, expenses which Lake River might have saved had Carborundum been forthright about its intent not to perform were in fact continuously incurred throughout the contract term.[28]

---

24. Carborundum Brief, *supra* note 18, at 15-16 (citation omitted).
25. *Id.* at 17.
26. Lake River Reply Brief, *supra* note 18, at 14.
27. Lake River Corp. v. Carborundum Co., No. 82 C 6292, slip op. at 4 (N.D. Ill. filed Mar. 15, 1984), *aff'd in part, rev'd in part*, 769 F.2d 1284 (7th Cir. 1985).
28. Lake River Reply Brief, *supra* note 18, at 10. The "forthright about its intent" language is typical of the over-the-top language in the briefs of both sides.

Lake River also claimed that Carborundum had "agreed to a higher minimum volume in return for a lower unit price."[29] I am suspicious of this statement since in its extensive recounting of the negotiations, Lake River did not identify any instance in which the contract price was reduced in exchange for an increase in the minimum volume.[30]

Both parties agreed that the contract had been breached and that the breach was Carborundum's failure to send the minimum amount of Ferro Carbo to Lake River. Had Lake River's counsel understood the transaction, he would have identified a different breach. At the end of the three years, the contract had been fully performed, save for Carborundum's failure to pay. That failure was the only breach. After summarizing Judge Posner's opinion, I will elaborate on that point.

II. POSNER'S DECISION

What has made the case so attractive to casebook authors was that Judge Posner was playing against type. Although he did not believe the rule against enforcement of penalty clauses made sense when dealing with agreements negotiated by sophisticated business parties, he felt bound by Illinois law.[31] He concluded that Paragraph 4 was an unenforceable penalty clause because, if the liquidated damages were awarded, Lake River's total compensation would always exceed what it would have earned had Carborundum met the minimum quantity. He began with a variant on Carborundum's argument:

> Suppose to begin with that the breach occurs the day after Lake River buys its new bagging system for $89,000 and before Carborundum ships any Ferro Carbo. Carborundum would owe Lake River $533,000. Since Lake River would have incurred at that point a total cost of only $89,000, its net gain from the breach would be $444,000. This is more than four times the profit of $107,000 (20 percent of the contract price of $533,000) that Lake River expected to make from the contract if it had been performed: a huge windfall.[32]

29. *Id.* at 2.
30. *Id.* at 8-11.
31. *Lake River Corp.*, 769 F.2d at 1288-89.
32. *Id.* at 1290.

Carborundum, in making the same point, had failed to subtract the cost of the bagging system, but that doesn't really matter since either number will do. The significant difference between the two formulations is more subtle. Carborundum, recall, asked what would happen if it had failed to deliver even one pound; its breach would not have occurred until the three years had expired. Posner's hypothetical involves a breach, or anticipatory repudiation, on day one. That raises a different issue, one that I will consider below.[33]

Posner then made calculations of Lake River's profit for various quantities short of the 22,500 ton minimum.[34] The expected cost at the minimum quantity was $533,000 less the 20% profit that Lake River had projected (although as noted above, they would not have achieved, because the cost projections were overly optimistic). He then assumed that the only fixed cost was the bagging system and that the variable costs were roughly proportional to the quantity.[35] 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.[36] For all quantities below the minimum, Lake River's net would exceed the profits had Carborundum met its minimum contract obligation. 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.[37]

Before turning to the contract itself, I should note 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

---

33. *See infra* Part IV.
34. This argument paralleled one made by Carborundum in its Reply Brief. Reply Brief of Defendant-Appellee and Cross-Appellant at 9, *Lake River Corp.*, 769 F.2d 1284 (Nos. 84-1623, 84-1688).
35. 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 $23.70x12,000 = $284,400. Variable costs were $15x12,000 = $180,000. Profits would have been revenue minus variable costs minus fixed costs, or $284,400-$180,000-$89,000 = $15,400. This number differs slightly from Posner's because of differences in rounding.
36. *Lake River Corp.*, 769 F.2d at 1290-91.
37. *Id.* at 1291.

assigned to Carborundum in 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 appear to do better than if it had produced the minimum. So, if we take the Illinois penalty clause language narrowly, the minimum payment of Paragraph 4 must always result in a compensatory payment in excess of Lake River's damages, and it should lose. The numerical illustration, right or wrong, adds nothing, save an exclamation point.

III. FRAMING THE DISPUTE

Posner's opinion did not consider any possible explanations for why the minimum payment might have been included in the contract. Although the contract itself was attached as an appendix to Lake River's brief,[38] neither the parties nor the courts invoked any of the other contract language. Two clauses are of particular importance, providing the context that was lacking in the briefs and the written opinions. 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

38. Lake River Brief, *supra* note 23, at App. 13.

> 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.[39]

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. (I have no idea why the maximum obligation was located in the middle of a clause dealing with other, largely mechanical, matters.) So, had Carborundum shipped the maximum each week it would have 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, cites the testimony of a Carborundum executive saying that the "equipment he recommended be purchased had the capacity to bag 10,000 tons per year," [40] roughly half the contractual maximum and one-third greater than the contractual minimum. Even though the facilities would be designed to handle 10,000 tons per year, Lake River was obligated to stand ready to handle twice that amount. Doing so might have entailed considerable extra costs. Or, perhaps, this was simply a drafting error. Regardless, it seems clear that Lake River had committed itself to being ready to bag up to 400 tons per week every week for three years.[41] The contract gave Carborundum considerable discretion regarding the timing. However, Lake River overstated Carborundum's flexibility, arguing that Lake River faced "*complete uncertainty* as to when Carborundum would ship the Product for bagging."[42]

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 some product if Carborundum delivered it. However, Carborundum did not promise to

39. *Id.* at 13-14.
40. *Id.* at 15.
41. If Carborundum had been taking the 400 ton maximum week after week, Lake River might have been able to limit its obligation by invoking U.C.C. § 2-306(1) (1978). I think that invoking "good faith" to trump contractual limits on quantity discretion is a bad idea, but it is plausible that if Lake River found the high demands burdensome, it could have successfully invoked the U.C.C. *See* GOLDBERG, *supra* note 1, at 101.
42. Lake River Reply Brief, *supra* note 18, at 5 (emphasis added).

deliver any product. Second, Lake River promised that it would stand ready to bag a certain amount of Ferro Carbo at a fixed price (subject to adjustment for labor costs), 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. So, if it received a better offer, had lower costs at its other facilities,[43] or if demand for its services fell off, it would have no obligation to use Lake River's services.

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 plain. The contract can be rephrased to make the structure clearer: Carborundum agrees to pay a flat rate of $533,000 over the course of the three years (subject to the labor cost adjustment) for the right to have 22,500 tons bagged during that period. Any additional tonnage will be billed at the rates set forth in the price schedule. The timing of the payment of the $533,000 depends on when Carborundum uses Lake River's services. Carborundum does not, however, commit to when, or if, it will send any product for bagging. It simply has an option. That option is constrained; it cannot require Lake River to bag more than 400 tons in a week.

Lake River provided a valuable service by standing ready to bag Carborundum's product. The minimum quantity/minimum payment served two functions (in addition to providing consideration).[44] 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.[45] Only for quantities greater than the minimum would Carborundum find it potentially profitable to shop.

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. It could decide whether to exercise its option (that is, use the facilities) after it learned more

43. After Lake River refused to release the product, Carborundum shipped from other facilities. The trial judge noted that "Carborundum has incurred additional costs and expenses for shipping and handling Ferro Carbo from other locations in order to meet its obligations to customers." Lake River Corp. v. Carborundum Co., No. 82 C 6292, slip op. at 6 (N.D. Ill. filed Mar. 15, 1984), *aff'd in part, rev'd in part*, 769 F.2d 1284 (7th Cir. 1985).

44. Absent the first clause of Paragraph 4, this would have been an illusory agreement.

45. As it turned out, $0 was too high.

about market conditions. 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. The price was not quoted explicitly. The higher the minimum, the greater the implicit price of the flexibility. 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.

When we recognize that the contract was one giving Carborundum substantial discretion for three years, then it is clear that Posner's characterization of the contract as still being executory is incorrect:

> 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.[46]

But, as Lake River's counsel asserted, it had fully performed; there was nothing left to execute. 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."[47]

Even if we were to treat the suspect clause as one stipulating damages, the expected damages are not confined to those 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."[48] 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 had to maintain sufficient capacity to

46. *Lake River Corp.*, 769 F.2d at 1287.
47. Lake River Reply Brief, *supra* note 18, at 10.
48. *Id.* at 7.

remain ready to meet this obligation; or, perhaps most important, it might have had to forego an attractive alternative. Lake River did note some of the additional costs, although it failed to mention the opportunity costs:

> 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 manpower between the Carborundum project and its other projects in light of the uncertainty over the timing of product shipments by Carborundum. [49]

If we treat payment for 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 be foregone) by Lake River because it had to stand ready to bag 400 tons per week for three years with 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."[50] So, even if we treat the minimum payment clause as subject to the penalty clause bar, a better understanding of the contract would make the liquidated damages characterization more plausible.

One doctrinal device for avoiding the penalty clause rule is to treat the payment as an "alternative performance."[51] Take-or-pay contracts, in which the buyer agrees to pay for a minimum whether it actually takes that quantity, have routinely been enforced. Posner attempted to distinguish this contract from a take-or-pay agreement,[52] even though neither party had raised the issue in its briefs. He distinguished, apparently, on the basis of the relative

49. *Id.* at 6.
50. *Lake River Corp.*, 769 F.2d at 1289.
51. *See* E. ALLAN FARNSWORTH, FARNSWORTH ON CONTRACTS § 12.18 n.44 (2d ed. 2001).
52. "We do not mean by this discussion to cast a cloud of doubt over the 'take or pay' clauses that are a common feature of contracts between natural gas pipeline companies and their customers." *Lake River Corp.*, 769 F.2d at 1292.

magnitude of the fixed costs: "If, as appears not to be the case here but would often be the case in supplying natural gas, a supplier's fixed costs were a very large fraction of his total costs, a take-or-pay clause might well be a reasonable liquidation of damages."[53] The high fixed cost, or more precisely, the specificity of an asset, is not the essential feature of the take-or-pay contracts. Asset specificity is, at most, a sufficient, but not necessary condition. The key feature is that the seller incurs costs by granting discretion to the buyer. A take-or-pay arrangement (say, between a coal mine and a power company) and this contract perform the same role in the same way. The party with discretion (Carborundum or the power company) has to pay the opposite party (Lake River or the coal mine) for the costs it could incur by affording that discretion. 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.[54]

IV. THE ANTICIPATORY REPUDIATION HYPO

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 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 could be offset by the value of the resources freed up by the termination.

Posner claimed that Lake River raised this argument: "Lake River argues that it would never get as much as the formula suggests, because it would be required to mitigate its damages."[55] I assume that this was raised in oral argument, because it was not in the briefs. He rejected the argument because, he claimed, it would undercut the virtues of liquidated damages.[56] However, 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

53. *Id.*

54. For further analysis of take-or-pay contracts see GOLDBERG, *supra* note 1, at ch. 5. Pay-or-play clauses perform the same role in movie contracts. *See id.* at ch. 15.

55. *Lake River Corp.*, 769 F.2d at 1291.

56. *Id.*

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, purposefully, 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.[57] 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.[58] 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, rather than as an essential element of the agreement defining the limits on Carborundum's discretion. 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.[59] I do not believe that the law requires identical treatment of a breach 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.

CONCLUDING REMARKS

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 for the seller to provide. 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

57. *See, e.g., Tractebel Energy Mktg. v. AEP Power Mktg.*, 487 F.3d 89 (2d Cir. 2007); *Roye Realty & Developing, Inc. v. Arkla, Inc.*, 863 P.2d 1150 (Okla. Sup. Ct. 1993).

58. *See* FARNSWORTH, *supra* note 51, § 12.12.

59. E-mail from Hon. Richard A. Posner to author, *supra* note 6.

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. For the latter, it is plausible that the damages should be offset by the non-breacher's gains from redeploying the freed-up assets. 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.[60]

60. For another, see GOLDBERG, *supra* note 1, ch. 17.