

# RENT CONCESSIONS, REIMPOSABLE DISCOUNTS, AND THE RETURN OF MEDIEVAL CONTRACT PENALTIES

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*... the suspicious word "penalty" will be avoided by the scrivener;  
the obligation will be for "lawful money" and the condition for the  
payment of a "just sum" or "full sum," as local practice dictates;  
—from *The Young Clerk's Guide* (1670)<sup>1</sup>*

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Penalty damages in contract have been contrary to Anglo-American law since the late Middle Ages, but under the guise of reimposable discounts are pervasive in modern consumer contracts. The reimposable discount is a late-twentieth-century sales scheme that combines legal puffery with illegal penalties. These pitches are used to sell furniture, appliances and cars, and more recently to rent apartments. The offers are tempting and often highly promoted on radio, television, the internet, and in newspapers. The common premise is that if the buyer acts now, the seller will discount the good or service by reducing the price, or by postponing the first payment and waiving the interest during that period. Reimposable discounts mimic true discounts with these enticements, but if the buyer breaches—either a fundamental breach or in some cases a minor breach such as late payment—then the discount is reimposed as stipulated damages.

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<sup>1</sup>See William H. Loyd, *Penalties and Forfeitures Before Peachy v. The Duke of Somerset*, 29 HARV. L. REV. 117, 121-22 (1915) (hereinafter *Penalties and Forfeitures*).

Consumer penalties are seldom challenged and rarely litigated. This leads to two significant negative impacts on the public in general and the unfortunate breaching buyer in particular. The first is found in Congress's recent move to make bankruptcy more difficult to obtain—the so-called Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.<sup>2</sup> Whatever the validity of Congress's view that consumers should be held more responsible for their debts, it is obvious that additional penalties unrelated to sellers' losses are unfair. What's worse, they unnecessarily compound consumer debt and multiply insolvencies.

The second impact is more subtle. Contract penalties have returned to common use at the same moment that tort penalties are in retreat, under attack from both legislatures and courts.<sup>3</sup> At first glance these would seem to be offsetting trends, but the opposite is true. While the consumers injured or killed by faulty products or incompetent service providers have declining remedies, the same consumers breaching contracts often face substantial penalties under the guise of reimposed discounts labeled as contractually-stipulated damages.

This is not to say that true liquidated damages are wrong. To the contrary, reasonable stipulations as to actual losses are quite legitimate, even in pre-printed form contracts that are entered without negotiation. In addition to their widespread legal acceptance, liquidated damage clauses serve valid social policies by providing fuller remedies for sellers and service providers, and do this efficiently in a court setting, thus holding down trial costs. What is not legitimate is the stipulation of money damages not directed to any contractual loss—direct, indirect, consequential, administrative or otherwise. The law has not changed in this area in four hundred years, but the penalties are there and for the most part are not being litigated.

This article focuses on the reimposable discount in residential leases, where the discount is termed a “rent concession.” Perhaps the sale of consumer goods provides the more common example, but this article arose from advice given and brief services rendered to clients in a landlord-tenant matter. Using the facts and documents from that dispute, this article will consider (1) the history of contract penalties, including their distinction from liquidated damages, (2) their illegality in the lease setting, (3) the economic arguments regarding contracted-for penalties, (4) the larger practice of reimposable discounts in consumer contracts, and (5) the consumer's lack of a realistic remedy in many cases. The article has no proposal for law reform. That occurred four centuries ago.

## I. RENT CONCESSIONS AND THE BREACHING TENANT

This fact scenario is supported in the author's records. Names, locations and exact dates

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<sup>2</sup>Pub. L. No. 109-8, 119 Stat. 23 (2005).

<sup>3</sup>For legislative reductions of tort remedies, *see e.g.*, <http://www.tortreform.com>; [http://pacificresearch.org/pub/sab/entrep/2006/tort\\_reform/index.html](http://pacificresearch.org/pub/sab/entrep/2006/tort_reform/index.html). For judicial restrictions under constitutional clauses, *see e.g.*, George C. Freeman, Jr. & Makram B. Jaber, *Further Progress in Defining Constitutional Restrictions on Punitive Damages and Other Monetary Punishments*, 61 BUS. LAWYER 517 (2006). For examples of existing and proposed federal legislative restrictions on state tort remedies, *see* Arthur H. Bryant, *Access to Justice at Risk*, NAT'L L. J. (March 28, 2005) at 22, available at <http://www.law.com/jps/nli/index.jsp>. *See generally* James P. George, *Access to Justice, Costs, and Legal Aid*, 54 AM. J. COMP. L. (Supp.) 293 (2006).

are changed to protect confidentiality, but all essential facts are true. Pam Martin is a twenty-six-year old single mother who now lives with her parents in a suburb of Fort Worth. Pam had earlier been sharing an apartment with a female co-worker. The apartment complex had leased them a two-bedroom apartment for a fourteen-month period. The two women signed a lease on a form prepared by the Texas Apartment Association. The lease's terms included provisions claiming that (1) the apartment had a "market rate" of \$975 a month, and (2) the tenants would receive a "rent concession" that would give them a \$200 a month discount. That is, they would pay only \$775 a month for the fourteen-month term. The lease also provided that if the tenants breached the lease, at least any breach involving a move out, the tenants would owe rent of \$975 a month for the remaining months in the term, and would also owe \$200 a month for the months in which the tenants had honored the lease.

Put another way, the rent was \$975 a month for fourteen months, but the tenants paid a reduced rate of \$775 a month as long as they did not terminate early. If they moved out before the end of fourteen months, the rent for the entire term would be \$975 a month multiplied by fourteen, with a credit for the rent paid at \$ 775 a month. The lease also had other damages provisions such as a reletting fee of \$ 824, late fees, and a possible clean-up charge. Pam and her roommate signed the lease and both initialed each page, purporting to represent that they had read and discussed each of the clauses relating to the discounted rent. In addition, Pam's parents co-signed the lease as guarantors.

Pam and her roommate moved into the apartment in June, 2004. In October, 2004, Pam's roommate accepted a job in another city and moved out. Pam asked if she could move into a one bedroom apartment. The landlord refused, as was its right. Pam moved out at the beginning of December, 2004, and moved in with her parents. A little under nine months remained on the fourteen-month lease. In January, 2005, Pam's father received a letter from a collection company demanding \$10,400. The collection demand also stated that the delinquent account would be sent to credit-reporting-service Experian, and that it would be posted there for up to seven years and would not be updated until the demand was paid in full. Read literally, this demand stated that even if the landlord was able to find a new tenant, which it did, the reported debt of \$10,400 would not be changed. True to this reading, neither the collection company nor the landlord changed the bad credit report when the apartment was relet two months later.

Pam and her parents ignored the letter. In August, 2006, when Pam's parents were negotiating to buy a new house, their financing was refused when the parents' credit report showed the bad debt for \$10,400. The Martins sought legal advice. Letters from their attorney to the collection agency and the landlord reduced the debt report from \$10,400 to \$4,400. This reflected the apartment's reletting, but the landlord continued to impose the \$824 reletting fee (which the Martins did not contest) and the \$200 rent concession for a seven-month period (the five months Pam lived there and the two months before reletting).

The collection company also responded to the Martins' demand for damages under the federal Fair Debt Collection Practices Act and similar Texas laws.<sup>4</sup> Specifically, the collection

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<sup>4</sup>These include the federal Fair Debt Collection Practices Act, 15 U.S.C.A. §§ 1692 et seq. (West 1998) (specifically 15 U.S.C. § 1692e (2)(A), (8), & (10)); the Texas Debt Collection Practices Act, TEX. FIN. CODE §§ 392.001 et seq. (Vernon 1998 & Supp. 2006) (specifically § 392.304(8)); and the Texas Deceptive Trade Practices-

company inquired how an attorney could possibly be making claims on behalf of people who did not pay debts? The answer, of course, is that the Martins had ignored a debt and without conceding any affirmative defenses at that point, the Martins might well owe for the remaining period on the lease up to the point of reletting. That is, the Martins had an obligation to make the landlord whole, to reimburse any actual damages from the breach, including rent and incidental fees. But the fact that the Martins had been at fault did not entitle the landlord to a \$200-a-month penalty. This collection agent's view is no doubt one reason that breaching tenants fail to seek legal advice on these consumer debt issues—they see themselves as deadbeats and assume that they owe not only what they would have paid, but the extra damages as well.

A second letter from the Martins' attorney offered to set off any amount the Martins might owe the landlord against the Martins' claim for damages under state and federal law. This offer assumed that the Martins' debt included the two months' rent at \$775 a month, plus the \$824 reletting fee and other incidental fees, but did not include the rent concession of \$1400 for the seven-month period. The collection company's response was that it had declared the account "inactive" and that any further communications should be made with the landlord. In a third letter, the Martins' attorney asked that "inactive account" be defined. Would it later become active? Would the debt allegation be removed from the Martins' credit reports? The collection agency did not respond. The landlord had never responded to any of the correspondence and ignored one additional letter.

The Martins are not being pursued at the moment and will not likely file suit to reduce or clear this debt. That puts them in company with a number of consumers, and the possible reasons for inaction are discussed in this article's conclusion.<sup>5</sup> Without judicial review, can we conclude that the reimposed rent concession in Pam's lease is an invalid penalty? The answer seems clear but is analyzed thoroughly in Section III of this article. The reimposed discount does not reimburse the landlord for any loss of money that it would have received had Pam remained there and paid through the lease's end. Neither does it reflect any other loss, tangible or otherwise, suffered by the landlord. It is nothing more than an incentive to perform, something that the Anglo-American contract law has widely rejected for four centuries.

## II. THE CONTRACT PENALTY IN ANGLO-AMERICAN LAW

Contract penalties, and specifically their illegality in the Anglo-American system, have a fascinating pedigree. The discussion begins with the vaguest sketches of early contract law and finds its way through the Roman *stipulatio* and the medieval English contract under seal, up to a 2006 discussion in the Texas Supreme Court. Its fashioners and renderers include Lord Mansfield, Sir Thomas Moore, Justice Story and Judge Posner, with social commentary from William Shakespeare

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Consumer Protection Act, TEX. BUS. & COM. CODE §§ 17.41 et seq. (Vernon 2002 & Supp. 2006) (specifically § 17.45(5), § 17.46(b)(7) and § 17.50(a)(3)).

<sup>5</sup>See *infra* Section III.C at notes 98-99 and accompanying text.

## A. Antiquity, Rome and England

Legal history suggests an inverse relationship between the use of contract penalties and the progress of social and legal systems—the growth of legal systems is the decline of penalties. The nature of contract law before the Roman Empire is unclear, but the scant evidence suggests that penalties were the exclusive contract remedy. The likely beginning of legal involvement in contract disputes is the advent of the executory contract, that is, the contract based on an agreement involving future performance by one or both parties.<sup>6</sup> In non-executory contracts—those completed on the spot—remedies were needed only for non-conforming goods, and history offers little evidence of legal resolutions for these disputes.<sup>7</sup>

These earliest executory contracts were based entirely on formalities. If the contract was in the proper form, often dictated by religion, it was enforceable and the only concern was compelling performance. This was done at first by religious sanctions, some as severe as excommunication. These eventually gave way to governmental sanctions; the simplest were fines and the most severe were the withdrawal of the law's protection. Another source of sanctions were those enforced by guilds and voluntary associations such as merchants. These penalties often outweighed the promisee's actual loss but had the advantage of promoting peaceful settlements.<sup>8</sup>

The influence of these pre-Roman legal systems is unclear, but whatever Rome may have drawn from them, the penalties continued. As the Roman Empire grew and trade increased, a natural result was increased use executory agreements where promises were made for the later delivery of goods. Lenders often financed these trade ventures, leading to the use of penalties for late payments even where religious laws barred the charging of interest. The perceived severity of those penalties led in turn to the development of usury laws, and with the lawyers' help, the

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<sup>6</sup>See generally I WILLIAM HERBERT PAGE, PAGE ON THE LAW OF CONTRACTS 2d ed. (1920) 3-5 (hereinafter PAGE). American contracts treatises tend to begin with the Roman Empire and ignore prior systems. Professor Page briefly addresses pre-Roman systems but cites only two sources. See *id.* at 4, note. Discussing contracts' legal evolution, Page describes the two executory contracts that we recognize today—the fully executory contract based on a formal promise with performance yet to come from both sides, and the partially executory contract where performance has been rendered by one side, creating an obligation for the other side. See *id.* The significance in Page's distinction is that the fully executory contract, that is, a promise with no performance from either side, drew its obligation from a religious base rather than what we would recognize as legal obligation, and had religious sanctions as remedies. See also I E. ALLEN FARNSWORTH, FARNSWORTH ON CONTRACTS 3d ed. § 1.4 (2004) at 11-13 (hereinafter FARNSWORTH). Sir Henry Maine's well-known treatise offers little more on pre-Roman contracts than speculation that prior to the Roman Empire, various jurisdictions' laws of contract were merely rudimentary attempts to resolve disputes among equals because inequals could not have mutually-enforceable agreements. See HENRY SUMNER MAINE, ANCIENT LAW (1866)(reprinted by Transaction Publishers, 2002) at 312-14. These accounts of pre-Roman contract law are further supported in non-legal historical references. See e.g., *Contracts*, 15 ENCYC. BRITANNICA 340-41 (2003).

<sup>7</sup>See PAGE, *supra* note 6 at 2-3 (contrasting the relatively sophisticated purpose of the modern legal system in rendering justice with the primitive legal system's goal of maintaining peace and avoiding violent remedies that occur outside a legal system).

<sup>8</sup>See PAGE, *supra* note 6 at 3-5.

circumvention of usury laws by creative drafting and alternative penalties.<sup>9</sup>

Credit transactions were not the only use of penal clauses, which became popular to ensure performance for a variety of acts and forbearance. These penal clauses took the form that we might recognize as bonds, and in fact were later termed “penal bonds” in England.<sup>10</sup> Roman law developed three forms of contracts, with penalties best suited to the stipulation contract.<sup>11</sup> *Stipulatio* was a written agreements to pay a fixed sum but releasing the obligation if the promisor performed the act. The amount of stipulated money had no limit other than the will of the parties, and Roman courts would enforce it in full even where it exceeded the value of the act or forbearance.<sup>12</sup> Even the Romans later saw the need to modify this practice and limit the award to actual damages, at least in some cases.<sup>13</sup> Often the obligor’s required performance was set on a date certain, but in some cases such as agreements for the use of land, it was simply attached to the term of the lease.<sup>14</sup> For lending transactions, *stipulatio* circumvented the usury ban by its legalistic formula of requiring a penalty if the money were not repaid by a fixed date. It was often no defense that the debtor was detained in his journey to the creditor’s home or otherwise paid a few days late. As with the earlier practice, the penalty was often strictly enforced.<sup>15</sup>

England, or Britannia during Roman times, was on the western edge of the pre-Columbian world and was primitive.<sup>16</sup> The Roman law of contracts faded in England when the empire failed and England’s primitive legal system had to re-develop those concepts.<sup>17</sup> Writings

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<sup>9</sup>“The rapid spread of this form of obligation is explained by the fact that it was well adapted to evade the canonical prohibition of interest on loans, regarded as usury and therefore unlawful for a Christian, and that by the time interest was made lawful it had become firmly established as a common form of conveyancing.” *Penalties and Forfeitures*, *supra* note 1 at 119.

<sup>10</sup>See III FARNSWORTH, *supra* note 6 at 302; *Penalties and Forfeitures*, *supra* note 1 at 119, 122.

<sup>11</sup>The other two forms of contract were “real” and “consensual.” Real contracts were partly executed and the promisor’s obligation arose not from the promise but the prior performance by the promisee. Consensual contracts were purely executory and thus based on the parties’ exchange of promises. Both real and consensual contracts lacked the formalities of the *stipulatio*. See I FARNSWORTH, *supra* note 6 at § 1.4, pp. 11-13.

<sup>12</sup>See *Penalties and Forfeitures*, *supra* note 1 at 117, citing to Justinian, Institutes, 3, 15, 7 (Moyle’s 5<sup>th</sup> ed.); Dig. 4, 8, 32; 21, 2, 56.

<sup>13</sup>*Id.* at 117-18, citing Hunter, Roman Law, 652, in turn citing Dig. 44, 4, 4, 3.

<sup>14</sup>See III FARNSWORTH, *supra* note 6 at 302. It is unclear at what stage the use of sureties became common, and *stipulatio* was also apparently used to bind the third party surety in addition to or instead of the obligor. *Id.*

<sup>15</sup>See *Penalties and Forfeitures*, *supra* note 1 at 119 and sources cited there. For civil law jurisdictions in Europe, the Roman practice has continued into the twentieth century, allowing for contractual penalties but with some jurisdictions authorizing the courts to modify the penalty if disproportionately high. See *id.* at 118 and sources cited there.

<sup>16</sup>See I FARNSWORTH, *supra* note 6 at 13.

<sup>17</sup>See *id.*

which evidenced executory contracts were rare before the latter part of the thirteenth century, and most instances of enforcing agreements related to obligations to the king or other governmental figures; otherwise there were no writings guaranteeing later performance or forbearance between private parties.<sup>18</sup> One reason may be the relative absence of purely private transactions in feudal kingdoms. In any event, the king's courts had the role of developing English contract law and were not inclined to adjudicate purely private agreements.<sup>19</sup>

To the extent that private parties entered unwritten executory agreements (or written agreements out of form), remedies were available outside the king's judicial system from at least three sources: ecclesiastical courts applying canon law, the commercial courts applying law merchant, and eventually the equity courts. The remedies there, as with earlier primitive systems, included penalties to induce performance rather than damages for breach.<sup>20</sup>

Two developments brought change. One was England's increased participation in trade with Europeans. Trade necessarily involved executory agreements, and often required financing which came from European lenders who insisted on penalties for late payment.<sup>21</sup> The second development was the increased use of wax seals in a practice based on the Roman *stipulatio*. The wax seal is an ancient means of validation, essential in the days when illiteracy was high. Seals were common in Roman law but England had been slow to adapt. At the time of the Norman Conquest, only the highest English nobles, dukes and above, possessed seals.<sup>22</sup> They were used to signify not only the noble's declarations, but also obligations that we would now consider private. Seals no doubt took the place of X marks and hand prints and thereby served as

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<sup>18</sup>Up to the late 1200s, court-enforced penalties typically involved agreements under which a penalty was to be paid to the king, the sheriff or to Westminster Abbey "for the relief of the Holy Land." See *Penalties and Forfeitures*, *supra* note 1 at 119, citing 2 POLLOCK & MAITLAND, 224, and further referring to John of Oxford's form book, 7 Law Quart. Rev. 65, displaying a penal bond from 1274.

<sup>19</sup>"[I]t is not the custom of the court of the lord king to portect private agreements, nor does it even concern itself with such contracts as can be considered to be like private agreements." R. DE GLANVILLE, TREATISE ON THE LAWS AND CUSTOMS OF THE REALM OF ENGLAND, bk. 10, ch. 18 (G. Hall, ed. 1965), quoted in I FARNSWORTH, *supra* note 6 at 15.

<sup>20</sup>See I FARNSWORTH, *supra* note 6 at § 1.5, pages 13-17. As with earlier legal systems, see *supra* note 8 and accompanying text, canon law enforced contracts through religious sanctions including excommunication. See *id.*

<sup>21</sup>See *Penalties and Forfeitures*, *supra* note 1 at 119. See also II SIR FREDERICK POLLOCK & FREDERIC WILLIAM MAITLAND, HISTORY OF ENGLISH LAW BEFORE THE TIME OF EDWARD I, 2d ed. (1896) (hereinafter POLLOCK & MAITLAND) at 225. This conclusion is best illustrated with the point that in that pre-Columbian times, Venice was the center of European trade while the relatively primitive England lay on the western edge of that world.

<sup>22</sup>The English use of seals contrasted from that in other kingdoms at that time. "In the France of Bracton's day the privilege of using a seal was confined to 'gentixhomes'; a man of lower degree would execute his bond by carrying it before his lord and procuring the apposition of his lord's seal. [footnote omitted] But in England as we have often seen, the law for the great became the law for all, and before the end of the thirteenth century the free and lawful man usually had a seal." POLLOCK & MAITLAND, *supra* note 21 at 223-24. In spite of England's slow acceptance of seals for routine transactions, seals were essential for public records prior to the Norman conquest. See *id.* at 223.

signatures for illiterate nobles. They were used for everything from royal decrees to simple correspondence where the seal's function included both sealing the envelope and authenticating the source.<sup>23</sup> Seals thus provided widely-accepted proof of both consent and authenticity, and eventually found their way into common use outside of royalty.

The increasing popularity of wax-sealed agreements resulted in better evidence, in turn leading to the courts' greater willingness to enforce the onerous remedies. As the adjudication of private agreements increased, the remedies for breach were bound up in the common law forms of action. The penal remedy was linked in particular to the action of covenant, which by the mid-fourteenth century required a wax-sealed instrument.<sup>24</sup> Penalties became especially popular for easements, rights of pasturage and feudal tithes. In many cases, the penalties were connected to borrowed money or other instances of credit, and accordingly ran into the developing concepts of usury.<sup>25</sup> But penalties in non-lending agreements did not encounter the usury bar and their practice became common.<sup>26</sup>

The use of sealed agreements in England had taken on such significance that by the fourteenth century, a contract under seal could be enforced on its face with no showing of the elements of contract or the presence of consideration.<sup>27</sup> The result in some cases was the automatic enforcement of penalties verbatim even for the slightest noncompliance with the terms of contract.<sup>28</sup> Unfair results led to negative judicial reaction and reform, perhaps additionally influenced by England's reaction to large and powerful European banks. Negative reaction occurred outside the legal system as well, best highlighted by Shakespeare's social comment with

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<sup>23</sup>See *History—Sigillography*, 20 ENCYC. BRITANNICA 611-13 (2003); *Contracts*, 15 ENCYC. BRITANNICA 341, 343 (2003). For online reference, see *Seals*, ENCYC. BRITANNICA (2006), <http://www.britannica.com/eb/article-9066471>. RESTATEMENT (SECOND) CONTRACTS § 96 cmt. a (1981); BLACK'S L. DICT. 1376 (8<sup>th</sup> ed. 2004); WEBSTER'S THIRD NEW INT'L DICT. OF THE ENGLISH LANGUAGE, UNABRIDGED (Philip Babcock Gove, ed. 1993) at 2046-47. See generally SIR HILARY JENKINSON, GUIDE TO SEALS IN THE PUBLIC RECORD OFFICE (1954).

<sup>24</sup>See I FARNSWORTH, *supra* note 6 at 15-16.

<sup>25</sup>See *Penalties and Forfeitures*, *supra* note 1 at 119-21.

<sup>26</sup>The English penal bond was a sealed instrument with a promise to pay a stated sum, further providing that this promise was null and void if the promisor rendered the required performance. See III FARNSWORTH, *supra* note 6 at 302. Farnsworth notes that this is similar to the still-used third party surety. It differs, however, in the amount obligated. Common law courts enforced penal bonds strictly and literally according to Farnsworth. If, then, the promisor did not meet every obligation under the contract, the common law courts would render judgment on the penal bond, regardless of the amount of loss suffered by the promisee. This had the effect of securing contract performance by making breach entirely unacceptable because of the resulting high penalty, a so-called *in terrorem* effect. See III FARNSWORTH, *supra* note 6 at 301.

<sup>27</sup>THEODORE F. T. PLUCKNETT, A CONCISE HISTORY OF THE COMMON LAW 5<sup>th</sup> ed. (1956) (hereinafter PLUNKNETT) at 633-34. Consideration was unknown at the time and did not set in until *Slade's Case* in 1602. *Id.* at 645-51.

<sup>28</sup>See III FARNSWORTH, *supra* note 6 at 302.



the pound of flesh demanded in *The Merchant of Venice*.<sup>29</sup>

Doctrinal relief from penalties—their outright proscription—did not come until the equity courts began issuing injunctions in the sixteenth century. Anecdotal relief came centuries earlier from both law and equity judges who were denying penalty clauses as early as 1308. In *Umfraville v. Lonstede*,<sup>30</sup> plaintiff brought an action in debt based on a writing that was supposed to have been delivered on a certain day. The defendant pleaded that he had been away from home but had left the task to an agent, that he had subsequently offered to deliver the writing, that plaintiff had suffered no damage by the short delay, and that defendant was again tendering performance as part of his answer. When Plaintiff rejected the defense and the tender, Lord Chief Justice Bereford responded:

You demand this debt because the writing was not delivered and he says that before now he has tendered it, and that he tenders it now. Therefore it is well that you receive it. Moreover, this is not, properly speaking, a debt; it is a penalty, and with what equity . . . can you demand this penalty?<sup>31</sup>

Bereford's twelfth-century reasoning remains one of the rationales for rejecting contract penalties. The plaintiff may have profited more from the breach than from performance, thus motivating plaintiff to reject performance on any grounds, or in some cases to create circumstances favoring a breach.<sup>32</sup>

For several hundred years, then, the negative reaction to penal bonds from both law and equity was merely case-specific, and penalties remained in use. The task fell to the chancery courts to fashion the doctrines that ultimately barred the penal bonds and contract penalties in general. The first categorical relief came by the beginning of the seventeenth century, addressed to cases where the obligor had incurred the penalty through his own negligent or unintentional

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<sup>29</sup>See William Shakespeare, *The Merchant of Venice* act 1, sc. 3, cited in POLLOCK & MAITLAND, *supra* note 21 at 225. See also *Penalties and Forfeitures*, *supra* note 1 at 123, observing that *The Merchant of Venice* “clearly indicates that the medieval mind was already, perhaps unconsciously, in revolt against the harshness, the excessive literalism of the law, of which the merchant’s bond was but a symbol.” See also Richard A. Posner, *Remarks on Law and Literature*, 23 LOY. U. CHI. L. J. 181, 183-85 (1991-92).

<sup>30</sup>See *Penalties and Forfeitures*, *supra* note 1 at 119, citing to Year Book, 2 & 3, Edw. II (Selden Society), p. 58. See also PLUCKNETT, *supra* note 27 at 677, citing Y.B. Edward II (Selden Society), ii. pp. xiii, 59. Bereford, a common law judge, was apparently using the term “equity” in a general sense, and not jurisdictionally.

<sup>31</sup>*Id.* Bereford was a law judge, sitting eventually as Lord Chief Justice on the Queen’s Bench. His use of the term “equity” is apparently generic rather than jurisdictional. This passage is alternatively reported as, “What equity would it be to award you the debt when the document is tendered and when you cannot show that you have been damaged by the detention. . . . Moreover this is not properly a debt but a penalty; and with what equity can you demand this penalty?” See PLUCKNETT, *supra* note 27 at 677, citing Y.B.B. Edward II (Selden Society), ii. pp. Xiii, 59.

<sup>32</sup>See generally *Penalties and Forfeitures*, *supra* note 1 at 120-25. See also PLUCKNETT, *supra* note 27 at 677-78.

acts, and where the harm to the obligee was minor.<sup>33</sup> Sir Thomas Moore urged the next step, which interestingly enough involved claims for nonpayment of rent. The procedure allowed the defaulting tenant to seek relief from chancery, which would enjoin the landlord from enforcing the penalty and require him to take the claim back to law courts to determine actual damages.<sup>34</sup> The equitable remedies became common enough to compel their direct application in the law courts, accomplished both by changes in the common law and by statute.<sup>35</sup> By the late seventeenth century, it came to be the view that society was better served if breaching the contract was an economic option if the breaching party was prepared to pay the other's loss. Equity courts were the forum, and they began enjoining penal bonds, then sending the case to trial in common law courts to determine the actual damages. This in turn led to statutes in England requiring the penal bond obligee to state the promisor's breach and then show actual damages.<sup>36</sup> This practice developed specifically in regard to penal bonds but later extended to a general bar of penal damages in contract.<sup>37</sup> These statutes came late enough and were sufficiently permanent that they applied to the American colonies, and were succeeded by new statutes after American independence.<sup>38</sup>

Penalties and usury have shared an interesting history. Under the concept of *stipulatio*, penal bonds and exorbitant interest rates developed together in Rome.<sup>39</sup> Later, when usury laws began restricting or barring the charging of interest, penalties in non-lending agreements flourished. In fact, lenders could sometimes circumvent usury laws by re-characterizing the clause as a penalty for breaches in performance.<sup>40</sup> In late medieval England, with penalties now facing categorical rejection, usury took a different path. What initially developed as a bar on interest in both loans and other contracts could not survive the growing trade and the emergence of capitalism, which was founded on credit. The absolute bar on interest was eliminated, but the bar on pure penalties remained.<sup>41</sup>

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<sup>33</sup>See *Penalties and Forfeitures*, *supra* note 1 at 124-25, and sources cited there.

<sup>34</sup>Certainly by the time of the Restoration it could be said that, "[i]t is a common case to give relief against the penalty of such bonds to perform covenants, etc, and to send it to a trial at law to ascertain the damages in a *quantum damnificatus*." *Penalties and Forfeitures*, *supra* note 1 at 125, quoting from I EQUITY CASES, Abr. 91. See also III FARNSWORTH, *supra* note 6 at 302.

<sup>35</sup>See *Penalties and Forfeitures*, *supra* note 1 at 126. See also PLUNKNETT, *supra* note 27 at 608.

<sup>36</sup>See III FARNSWORTH, *supra* note 6 at 302.

<sup>37</sup>*Id.*

<sup>38</sup>See *Penalties and Forfeitures*, *supra* note 1 at 126, citing S. D. Wilson, Courts of Chancery in the American Colonies, 19 Amer. L. Rev. 226. See also III FARNSWORTH, *supra* note 6 at 302.

<sup>39</sup>See *supra* notes 6-14 and accompanying text.

<sup>40</sup>See *supra* note 15 and accompanying text.

<sup>41</sup>See *Penalties and Forfeitures*, *supra* note 1 at 121.

## B. The American View

The American colonies' adoption of English law was irregular and saw both reactions and reform. One reform promoted freedom of contract, and this encouraged the evolution of contracts with stipulated damages. Some met the definition of penalties, but even where the colonial courts enforced them, a rule of reason prevailed. One example is *Tall v. Ryland*, a 1670 colonial opinion based on Tall's equitable action to enjoin a law verdict requiring him to forfeit a £ 20 bond.<sup>42</sup> Tall and Ryland were fishmongers with contiguous shops, and Tall had executed the bond as assurance that he would not disparage Ryland's fish. Tall fell short of his pledge when he asked a customer why he would buy fish from Ryland, because Ryland's fish stunk. Ryland sued on the bond and won. Following the English procedure, Tall brought the equitable action to enjoin the penalty, but the chancery judge sustained Ryland's demurrer. The equity court held that the bond related to an agreement "to preserve amity and neighborly friendship" and that Ryland had sustained damage for which £ 20 was a fair estimate. In finding for Ryland, however, the judge noted that this was "not to be a precedent in the case of a bond of £ 100 or the like."<sup>43</sup>

In assessing this case's meaning, it is noteworthy that Ryland's claim would be readily accepted by courts today for a tort action for defamation or business disparagement. Because Tall and Ryland had already agreed on the bond and its terms, it is easy to understand why a court might find it enforceable. Moreover, the parties' liquidated damages clause for £ 20 would likely be upheld today as a reasonable assessment of unquantifiable damages for business disparagement. But the most important point is that the 1670 equity court was consistent with the law today in its dictum that an unreasonably high bond would not be enforced. The unstated rule is that liquidated damages which are unreasonably high amount to a penalty.<sup>44</sup>

American law, both common law and statutory, has largely followed the English ban on contract penalties. In his seminal work *Equity Jurisprudence*, Joseph Story disputed views that questioned courts' ability to interfere with stipulated damages:

There is no more intrinsic sanctity in stipulations by contract than in other solemn acts of the parties which are constantly interfered with by courts of equity upon the broad grounds of public policy on the pure principles of natural justice.<sup>45</sup>

A century and a half later, Professor Farnsworth traced the American view from a three-element test for improper stipulated damages to a single principle of just compensation for actual

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<sup>42</sup>See *Penalties and Forfeitures*, *supra* note 1 at 128, citing and quoting I CASES IN CHANCERY, 183 (1670), S. C. I Eq. Ca. Abr. 91.

<sup>43</sup>*Id.*

<sup>44</sup>See *Penalties and Forfeitures*, *supra* note 1 at 129 and note 50, citing several cases on this point from 1674 through 1891.

<sup>45</sup>*Id.* at 126, quoting 2 JOSEPH STORY, EQUITY JURISPRUDENCE, 13<sup>th</sup> ed. (1886) § 1316.

damages.<sup>46</sup> American law reflects this in any number of cases and articles,<sup>47</sup> but the best expression may belong to Judge Posner, writing as judge but with his usual scholarly insight. *Lake River Corporation v. Carborundum Company*<sup>48</sup> was a dispute in which a warehouse operator sought recovery of contractually agreed damages for a manufacturer's breach of a distribution agreement. The product was "Ferro Carbo," an abrasive powder used in steel production. To better serve its midwestern customers, manufacturer Carborundum asked that Lake River, operator of an Illinois warehouse, serve as distributor. In the resulting contract, Lake River was to receive Ferro Carbo in bulk, package it in bags, and ship the bags to Carborundum's customers, with Carborundum retaining title until delivery to the customer. To package the Ferro Carbo, Lake River had to install a new bagging system at a cost of \$89,000. To ensure recover of this cost and the agreed-to profit of twenty percent, Lake River negotiated a minimum-quantity guarantee of 22,500 tons over a three-year period. That clause further stated that if the minimum quantity was not shipped at the end of the three-year term, that Lake River had the right to invoice Carborundum for the difference between the quantity bagged and the minimum guaranteed.<sup>49</sup>

The parties signed the contract in 1979, but the price of steel soon dropped and when the contract expired in 1982, Carborundum had shipped only 12,000 of the promised 22,500 tons. Had the contract been performed in full, Lake River would have profited approximately \$ 553,000, and when the contract ended, it demanded the anticipated balance of \$ 241,000. Carborundum refused, arguing that this was not liquidated damages, but instead an unenforceable penalty. Making the case more litigable, Lake River still had 500 tons of Ferro Carbo with a market value of \$269,000, and it refused release until Carborundum paid the contractually-agreed damages. Lake River offered to sell the Ferro Carbo and place the funds in escrow, but Carborundum rejected that and instead trucked in its product for those customers, at an additional cost of \$31,000. Lake River sued in federal court for \$ 241,000, and Carborundum counterclaimed for conversion. The trial court found in both parties' favor, that is, that Lake River was entitled to the contract damages of \$241,000 plus \$17,000 in prejudgment interest, but that Lake River in turn had wrongfully converted the inventory and owed Carborundum \$269,000 plus \$31,000 for the extra cost of shipping. Both parties appealed.<sup>50</sup>

The trial court had held that if the minimum guarantee clause was a penalty clause and

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<sup>46</sup>The original three elements justifying liquidated damages were that (1) the damages must be uncertain or difficult to prove; (2) the parties must intend to liquidate them in advance; and (3) the stipulated amount must be reasonable. See III FARNSWORTH, *supra* note 6 at 305, discussing *Banta v. Stanford Motor Co.*, 89 Conn. 51, 92 A. 665 (1914). Farnsworth explains that an increased emphasis on contracting freedom and the development of the doctrine of unconscionability led to the de-emphasis of the first two elements, leaving the lone element of just compensation. See *id.*

<sup>47</sup>See generally III FARNSWORTH, *supra* note 6 at 300-23.

<sup>48</sup>769 F.2d 1284 (7<sup>th</sup> Cir. 1985).

<sup>49</sup>*Id.* at 1286.

<sup>50</sup>*Id.* at 1286-87.

therefore unenforceable, then the lien would not be valid. Judge Posner's panel found error here because even if the liquidated damages provision was an illegal penalty, Lake River might nonetheless be able to prove actual damages for which an inventory lien was valid. Noting that Lake River had not been able to identify the type of lien it was asserting, the court likened it to an artisan's or bailee's lien, that is, one imposed on goods on which services had been rendered without payment. The court then held such a lien to be inappropriate under these facts because Carborundum had paid for all services up to that point. Its only breach had been the failure to ship the additional Ferro Carbo, up to the guaranteed minimum. Thus Lake River was holding the Ferro Carbo not for payment of an existing debt, but to pressure Carborundum into paying the liquidated damages on the Ferro Carbo that had not been shipped. In turn, Lake River had not incurred expenses in bagging or delivering the unshipped Ferro Carbo, a point which plays into the court's conclusion that Lake River was pursuing a penalty.<sup>51</sup>

Turning to the damages issue, Judge Posner acknowledged an inclination to question whether the historic ban on penalty clauses was appropriate. This dicta produced two arguable policy reasons for upholding contractual penalties. First, parties agreeing to penalties for breach are providing an earnest of performance. The willingness to suffer a penalty that clearly exceeds actual damages enhances the promisor's credibility and may enable the promisor to enter contracts otherwise closed off.<sup>52</sup> Second, penalty clauses may discourage both efficient and inefficient breaches. An efficient breach is one done purposefully in order to maximize the breaching party's gain because of conditions arising after the contract's creation. Posner used the example of a breach which will cost the breaching party \$12,000 in payment to the other party, but will earn the breaching party \$20,000 elsewhere. Even though efficient breaches are good in a macro-economic sense because they produce a net gain, they can be nuisances to some contracting parties. Penalty clauses that nullify the breaching party's gain help ensure specific performance without resorting to courts.<sup>53</sup>

Judge Posner explained the utility of penalty clauses by distinguishing efficient breaches from inefficient ones, with the latter defined as breaches costing the promisee more than the gain to the breaching promisor. Posner concluded that because compensatory damages are sufficient for inefficient breaches, the social utility of penalty clauses is limited to the deterrent effect on efficient breaches. Exceptions and counter-arguments exist here as well. One is that penalty clauses are justifiable because for all contracts, they enhance the promisor's credibility and thereby create access to otherwise unavailable contracts. A final Posner dictum—important to this article's point—is that

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<sup>51</sup>*Id.* at 1287-88. The court further rejected Lake River's argument that contrary to the court's analysis, it had sustained actual damages in its purchase of the bagging equipment which now would have to be amortized over the sale of 12,500 rather than 22,500 tons of Ferro Carbo. The court found that not only did Lake River use the bagging equipment for other jobs, but that amortization was a mere accounting entry and need not reflect cash flows. In so holding, the court was not rejecting Lake River's claiming of that \$ 89,000 cost of the bagging equipment, but merely holding that Lake River would have to prove such damages conventionally. *Id.* at 1288.

<sup>52</sup>*Id.* at 1289.

<sup>53</sup>*Id.*

. . . parties (always assuming they are fully competent) will, in deciding whether to include a penalty clause in their contract, weigh the gains against the costs—costs that include the possibility of discouraging an efficient breach somewhere down the road—and will include the clause only if the benefits exceed those costs as well as all other costs.<sup>54</sup>

Assuming full merit for Judge Posner’s arguments for the utility of penalty clauses, those arguments do not support their enforcement in adhesion consumer contracts consummated with little or no negotiation between parties of significantly disparate bargaining power.<sup>55</sup>

Having made the argument for penalty clauses in some economic settings, Judge Posner then acknowledged that this economic view is not the law, not in Illinois and not in the United States.<sup>56</sup> Under *Lake River*’s legal summary, liquidated 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

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<sup>54</sup>*Id.*

<sup>55</sup>For a convenient summary of the scholarly analyses of contract penalties, see Avery W. Katz, *Remedies for Breach of Contract Under the CISG*, 25 INT’L REV. L. & ECON. 378, 386-87 (2005). Professor Katz’s discussion cites to articles for and against “supracompensatory damages” in both domestic and international commercial settings, with little if any application to consumer sales. These articles include Charles J. Goetz & Robert E. Scott, *Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes of an Enforcement Model and a Theory of Efficient Breach*, 77 COLUM. L. REV. 544 (1977) (hereinafter *Liquidated Damages, Penalties and the Just Compensation Principle*); Samuel A. Rea, Jr., *Efficiency Implications of Penalties and Liquidated Damages*, 13 J. LEGAL STUD. 147 (1984); Philippe Aghion and Patrick Bolton, *Contracts as Barriers to Entry*, 77 AM. ECON. REV. 388 (1987); Tai-Yeong Chung, *On the Social Optimality of Liquidated Damages Clauses: An Economic Analysis*, 8 J. L. ECON. & ORG. 280 (1992); Aaron S. Edlin and Alan Schwartz, *Optimal Penalties in Contracts*, 78 CHI.-KENT L. REV. 33 (2003); Alan Schwartz, *The Myth That Promises Prefer Supracompensatory Remedies: An Analysis of Contracting for Damages Measures*, 100 YALE L. J. 369 (1990); Aaron S. Edlin, *Cadillac Contracts and Up-Front Payments: Efficient Investment Under Expectation Damages*, 12 J. L. ECON. & ORG. 98 (1996); Aaron S. Edlin and Stefan Reichelstein, *Holdups, Standard Breach, and Optimal Investment*, 86 AM. ECON. REV. 478 (1996); Eric Maskin and Jean Tirole, *Unforeseen Contingencies and Incomplete Contracts*, 66 REV. ECON. STUD. 83 (1999); Avery W. Katz, *The Option Element in Contracting*, 90 VA. L. REV. 2187 (2004); Robert E. Scott and George G. Triantis, *Embedded Options and the Case Against Compensation in Contract Law*, 104 COLUM. L. REV. 1428 (2004). See also articles listed at III FARNSWORTH, *supra* note 6 at 303, n. 8. For an article addressing adhesion issues in consumer contracts but not including penalties, see “Boilerplate” Foundations of Market Contracts Symposium, 104 MICH. L. REV. 821-1246 (2006) (generally discussing adhesion agreements with no focused discussion of penalty damages).

<sup>56</sup>“ . . . we must be on guard to avoid importing our own ideas of sound public policy into an area where our proper judicial role is more than usually deferential. The responsibility for making innovations in the common law of Illinois rests with the courts of Illinois, and not with the federal courts in Illinois. *And like every other state*, Illinois, untroubled by academic skepticism on the wisdom of refusing to enforce penalty clauses against sophisticated promisors, . . . continues steadfastly to insist on the distinction between penalties and liquidated damages.” 769 F.2d at 1289 (emphasis added) (citations omitted).

upper estimate of what the damage are likely to be, it is a penalty.<sup>57</sup>

Applying the rule to the *Lake River* facts, Judge Posner acknowledged that the penalty/liquidated damages distinction is often difficult and rests on facts peculiar to each case. For Lake River's contract, however, the clause was clearly a penalty because it was "designed always to assure Lake River more than its actual damages,"<sup>58</sup> a conclusion supported by a series of hypotheticals demonstrating Lake River's loss at various times in the term of the contract. The clause failed to calculate that Lake River would gain by not having to incur its own performance costs, and instead guaranteed it a profit. In reaching this conclusion, Posner carefully distinguishes valid liquidated damages, using a case law example of an employment agreement which docked the employee four percent of his salary for early resignation, and did so in addition to the employee's loss of the remaining months' salary. This was a valid estimate of the damage to the employer in finding a replacement, even though the four percent measure will increase with higher-paid employees.

*Lake River* performs multiple functions in American jurisprudence. It explores the policy arguments for contracted-for penalties in limited settings, typically involving parties of equal bargaining power who are negotiating agreements in which guarantees or other features are especially important. It acknowledges that in spite of significant scholarly support for these arguments, American law has uniformly retained the English ban on contract penalties that cannot meet the test for liquidated damages. It articulates the liquidated damages test and provides a nuanced distinction between those valid damages and illegal penalties.

### C. Texas Law as the Situs State

Judge Posner's summary of American law in *Lake River* does not necessarily answer the question for the Martins in Texas. The penalty rule, however, does not vary in Texas law, which strongly supports Posner's conclusion that the rule against contract penalties has been widely upheld in the United States. Texas courts applied the rule as early as 1854 in *Durst v. Swift*, an action for damages for defendant's failure to deliver various land titles in several counties in southeast Texas.<sup>59</sup> The contract stipulated the damages and defendant objected that this was a penalty. The trial court disagreed that it was a penalty, and in upholding that decision, the Texas Supreme Court recited the rule, from English and American sources, distinguishing proper liquidated damages from penalties.

Where the parties, in the agreement, have expressly declared the sum to be intended as a forfeiture, or penalty, and no other intention is to be gathered from the instrument; where it is doubtful whether it was intended as a penalty, or not; and a certain damage, or debt, less than the penalty, is made payable on the face of the instrument; where the agreement

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<sup>57</sup>*Id.* citing Illinois case law.

<sup>58</sup>*Id.* at 1290.

<sup>59</sup>11 Tex. 273 (1854).

was evidently made for the attainment of another object, to which the sum specified is wholly collateral; where the agreement contains several matters of different degrees of importance, and yet the sum is payable for the breach of any, even the least; and where the contract is not under seal, and the damages are capable of being certainly known and estimated in all these cases the sum stipulated has been treated as a penalty.<sup>60</sup>

A last clause in the last sentence is important: “. . . in all these cases the sum stipulated has been treated as a penalty.” The factors listed in this paragraph are not cumulative. Any one factor can defeat the fixed damages provision in a contract. *Durst* shows the ready understanding courts had in 1854 of the liquidated damages and penalty distinction. It was developed law, easily imported into Texas’s nascent judicial system. *Durst* further shows that in spite of the presumption that stipulated damages are illegal penalties, that liquidated damages are appropriate where, as in that case, “the damages are uncertain, and are not capable of being ascertained by any satisfactory and known rule; . . .”<sup>61</sup>

Texas courts considered the rule several times over the years, but *Stewart v. Basey*<sup>62</sup>—a 1952 case—may provide the best and most current statement. All the more appropriate for this discussion, it involved a rental agreement. Stewart was a commercial landlord in Austin. In 1949, he leased three buildings on Congress Street in Austin to Basey for a stated term of five years. The written lease in fact stated a term spanning six years, although the court resolved the questions without worrying about that discrepancy. The rent was \$325 a month and the lease began on January 1, 1949. Basey only paid through November 1 of that year and then moved out. Stewart then sued, seeking to collect on the lease’s clause that stipulated \$150 damages for each remaining month on the lease. Importantly, the damage provision applied for any breach of the lease.<sup>63</sup> The trial court found that provision to be a penalty, but awarded Stewart \$38.50 for damage to a door, and the court of appeals reversed that.<sup>64</sup> In affirming the court of appeals, the Texas Supreme Court examined Texas case law starting with *Durst* and noted the wide agreement on this rule in the United States as reflected in the Restatement of Contracts and

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<sup>60</sup>*Id.* at 282.

<sup>61</sup>*Id.*

<sup>62</sup>245 S.W.2d 484 (Tex. 1952).

<sup>63</sup>The lease stated: “The failure to pay any monthly installment of rental when such installment is due shall terminate this lease at the option of Lessors. The failure of Lessee to make said payment of payments or the breach of this contract otherwise by him shall render him liable to Lessors, as agreed liquidated damages, the sum of One Hundred Fifty (150) Dollars per month for each and every month of the unexpired term of the lease which shall become due and payable when the option to terminate this lease is exercised or at the time of the breach of this contract otherwise by Lessee if any, and the payment thereof be secured by lien on the property of Lessee in said Store Buildings at said time.” *Id.* at 485.

<sup>64</sup>*Id.* at 485.



leading treatises.<sup>65</sup> The *Stewart* rule summarized Texas law that “to be enforceable as liquidated damages, the damages must be uncertain and the stipulation must be reasonable.”<sup>66</sup> A further discussion drawn from *Williston* adds the element that reasonableness means a good faith effort to assess otherwise unquantifiable damages.<sup>67</sup> Perhaps more important, *Stewart* states the underlying policy against contract penalties or any remedy that over-compensates for contract breaches.

The universal rule for measuring damages for the breach of contract is just compensation for the loss or damage actually sustained. By the operation of that rule a party generally should be awarded neither less nor more than his actual damages. A party has no right to have a court enforce a stipulation which violates the principle underlying that rule. In those cases in which courts enforce stipulations of the parties as a measure of damages for the breach of covenants, the principle of just compensation is not abandoned and another principle substituted therefor. What courts really do in these cases is to permit the parties to estimate in advance the amount of damages, provided they adhere to the principle of just compensation.<sup>68</sup>

In summarizing this policy drawn from the Restatement of Contracts, the *Stewart* opinion stated the rule that now controls in this area and may be the most accurate statement of judicial oversight for contractually-stipulated damages.<sup>69</sup>

The court then addressed the lease in front of it and found that the \$150 a month stipulation was indeed a penalty because it far exceeded any actual damage the landlord had suffered. The court also upheld the court of appeals’ reversal of the \$ 38.50 for damages to the door, leaving the landlord with nothing.<sup>70</sup> But what about the landlord’s entitlement to rent at \$325 a month for the remaining months on the lease? The opinion does not tell us whether the lease had such a covenant and does not recite the relevant law for 1952. We do know that the

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<sup>65</sup>“Volumes have been written on the question of when a stipulated damage provision of a contract should be enforced as liquidated damages and when enforcement should be denied because it is a penalty provision.” *Id.* at 485-86. *See generally id.* at 485-87. In addition to the Restatement of Contracts § 339, the *Stewart* opinion cites 3 WILLISTON ON CONTRACTS (rev. ed.) § 783 at 2204; MCCORMICK ON DAMAGES § 151; and legal encyclopedias. *Id.* at 487.

<sup>66</sup>*Id.* at 486.

<sup>67</sup>*Id.* at 486, citing to WILLISTON ON CONTRACTS, rev. ed. at 2179.

<sup>68</sup>*Id.* at 486, citing the RESTATEMENT OF CONTRACTS § 339. *Stewart*’s limiting the measure of contract damages to just compensation for the actual loss is consistent with Farnsworth’s description of American law generally. *See* III FARNSWORTH, *supra* note 6 at 300-05, especially *Jaquith v. Hudson*, 5 Mich. 123 (1858), discussed *id.* at 301.

<sup>69</sup>*See* III FARNSWORTH, *supra* note 6 at 305-08.

<sup>70</sup>*Id.* at 487.

landlord quickly relet the buildings by the time of trial.<sup>71</sup> We also know, if the opinion reflects the court record, that the landlord did not seek such damages for any time the building was empty, but instead sought only the \$150 a month for the five or more years remaining on the lease. That is, the landlord pursued only his remedy under the stipulated damages provision, and it failed because it did not realistically measure any actual damage the landlord had suffered.

Reported Texas decisions have cited *Stewart* at least two dozen times, some invoking the rule, some distinguishing the facts and finding appropriate liquidated damages, but none questioning the rule. Two cases merit short discussion. In 1991 the Texas Supreme Court applied *Stewart*'s bar on contract penalties in *Phillips v. Phillips*.<sup>72</sup> When Harry and Martha Phillips divorced after thirty-two years of marriage, they placed their considerable community property—mostly based on oil and gas holdings—into a limited partnership. Harry was the general partner and Martha was the only limited partner. Harry's duties included the distribution of funds to himself and Martha and various routine reporting and fiduciary duties. The agreement included the following clause that if Harry breached his duties, he would pay liquidated damages of ten times Martha's actual loss.<sup>73</sup> Harry did breach by short-funding the distributions and overcharging for his own expenses. The trial court enforced that clause, but the Tyler court of appeals reversed and the Texas Supreme Court affirmed. Justice Hecht's majority opinion found the ten-time multiplier to be a penalty because it clearly violated *Stewart*'s two-prong rule that liquidated damages be incapable or difficult of estimation, and a good faith assessment of actual damages. To the contrary, the Phillips's agreement linked the ten-time multiplier to an initial determination of actual damages. This, the *Phillips* majority concluded, was on its face an unenforceable penalty.<sup>74</sup>

The *Phillips* dissent, and the majority's rejection of that argument, add an important footnote to the *Stewart* rule. When Martha Phillips sued, Harry had failed to plead his penalty argument as an affirmative defense. Three justices keyed their dissent to what they argued was the clear requirement under Texas procedural rules that matters such as this be affirmatively raised by the defense.<sup>75</sup> The majority rejected this, finding an exception to the requirement of affirmative pleading where the matter in question is illegal and apparent on the face of the plaintiff's claim. As the court stated, "[e]nforcement of a penalty, like enforcement of an illegal contract, violates public policy."<sup>76</sup>

In 2006, the Texas Supreme Court made an important distinction regarding the *Stewart* rule. *Flores v. Millennium Interests, Ltd.* was a certified question from the federal Fifth Circuit Court of Appeals, involving the interpretation of the term "liquidated damages" in a section of

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<sup>71</sup>*Id.* at 485.

<sup>72</sup>820 S.W.2d 785 (Tex. 1991).

<sup>73</sup>*Id.* at 786-87.

<sup>74</sup>*Id.* at 787-89.

<sup>75</sup>*Id.* at 790-92 (Gonzalez dissenting based on Tex. R. Civ. P. 94).

<sup>76</sup>*Id.* at 789-90.

the Texas Property Code.<sup>77</sup> Specifically, a seller under certain contracts for deed faces “liquidated damages” of \$250 a day for certain violations. The federal appellate court submitted questions regarding this provision’s penalty nature and whether it required proof of actual damages. The Texas Supreme Court explained that the Texas Legislature had used the term “liquidated damages” here to mean a penalty, and that it was automatic and did not require proof of actual damages. Summarizing the *Stewart* rule and distinguishing it from the statute in *Flores*, the court stated:

The term “liquidated damages” ordinarily refers to an acceptable measure of damages that parties stipulate in advance will be assessed in the event of a contract breach. The common law and the Uniform Commercial Code have long recognized a distinction between liquidated damages and penalties. If damages for the prospective breach of a contract are difficult to measure and the stipulated damages are a reasonable estimate of actual damages, then such a provision is valid and enforceable as “liquidated damages;” otherwise it is void as a “penalty.”<sup>78</sup>

The court went on to point out that while many Texas statutes reflected this general rule, some statutes used the term “liquidated damages” synonymously with “penalty.” In fact, of the twelve Texas statutes mentioning liquidated damages, nine regulate them consistent with the Stewart rule, while three use the term liquidated damages to create a civil penalty such as the one in *Flores* under the Property Code.<sup>79</sup>

In *Flores*, the Texas Supreme Court may have been hasty in labeling these provisions as nothing more than penalties. Although the \$250-a-day measure applies regardless of the property’s value, this can be characterized as a legislative attempt to award damages for inconvenience and other loss beyond the measured monetary loss, and to do so without the complications of proof at trial. But even if the legislature intended these “liquidated damages” as pure civil penalties, the necessary conclusion is that the law penalizes wrongful conduct. In any event, *Flores* underscores that these few statutory usages of “liquidated damages” as penalties must be distinguished from the centuries-old common law rule barring contract penalties.

As *Flores* pointed out, the law of contracts goes beyond the common law. Contracts have also been regulated by statutes since late medieval England, including one that codified the equity courts’ requirement that contract damages be limited to the actual loss sustained.<sup>80</sup> But what about other areas of contract law, where legislatures and uniform codes codified entire

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<sup>77</sup>185 S.W.3d 427 (Tex. 2005), construing TEX. PROP. CODE § 5.077 (Vernon Supp. 2006).

<sup>78</sup>185 S.W. 3d at 431 (citations omitted).

<sup>79</sup>*Id.* at 431. The other two Texas statutes treating “liquidated damages” as a penalty provision are TEX. LABOR CODE § 62.201 (Vernon 2006) (for violations of the minimum wage law), and TEX. AGRIC. CODE § 52.106(d)(1) (Vernon 2004) (allowing a marketing association to “fix as liquidated damages a specific amount to be paid by a member if the member breaches the marketing contract”). See 185 S.W.3d at 432 notes 4 & 5.

<sup>80</sup>See III FARNSWORTH, *supra* note 6 at 302-03.

subsets of contract law? An exhaustive answer is not feasible here, but one good example appears in the Uniform Commercial Code, and specifically in the Uniform Commercial Code's section 2-718 governing liquidated damages in contracts for the sale of goods.<sup>81</sup> Section 2-718 has no application to any discussion of residential leases, but it exemplifies the pervasive ban on penalty damages in Anglo-American contract law.

Summarizing the law's view of contract penalties, it is notable that the earliest societies had the most severe penalties, and as social and legal systems progressed, the penalties became less severe. Late medieval England had the greatest negative reaction to penalties and that view remains today in the United States. Economists have questioned the Anglo-American rejection of penalties and have argued for their utility in limited contract settings involving parties of equal bargaining power, but none of these arguments can be applied to form-printed consumer contracts.

### III. DISCOUNTS AND OTHER PURCHASE INCENTIVES AS PENALTIES

English and American law have declared contract penalties illegal for four centuries, and suspect for seven. As that legal imperative persisted over these many years, people with the upper hand in drafting contracts have attempted innovations to get around the ban on penalties. Ample case law reflects these attempts, mostly in commercial settings between parties of somewhat equal bargaining strength. As the treatises reflect, these penalties have most often been disguised as liquidated damages. The more clever drafters heed the rule by characterizing the damages as good faith estimates of the promisee's actual loss, highlighting the loss and the likely inability to ascertain that loss accurately. Courts have seen through this by ignoring labels and treating the contractual terms for their actual function and result.<sup>82</sup>

In what may be the most clever drafting innovation to date, many consumer contracts

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<sup>81</sup>Section 2-718 was amended in 2003, with no substantive change regarding consumer contracts but easing the burden of proof for plaintiffs in commercial cases. As of the time of this publication, no states have adopted the amended version. However, this strikeout version, taken from the official text, reflects that the UCC's rule on liquidated damages has been consistent with the common law and did not change with the 2003 amendments. The standard and amended sections read:

“Damages for breach by either party may be liquidated in the agreement but only at an amount ~~which~~ that is reasonable in the light of the anticipated or actual harm caused by the breach and, in a consumer contract, the difficulties of proof of loss, and the inconvenience or non-feasibility of otherwise obtaining an adequate remedy. ~~A term fixing unreasonably large liquidated damages is void as a penalty. Section 2-719 determines the enforceability of a term that limits but does not liquidate damages.~~”

Amended art. 2-718, 1 U.L.A. Master Ed. (2004) at 549. Official Comment 2 to the 2003 version states in part: “Under original Section 2-718, a party seeking to enforce a liquidated damages term had to demonstrate the difficulty of proving the loss and the inconvenience or nonfeasibility of obtaining an adequate remedy. These requirements have been eliminated in commercial contracts but are retained in consumer contracts.” In other words, the 2003 insertion of “and, in a consumer contract” was intended to ease the burden of proof for plaintiffs in commercial contracts who were on a more even footing with the breaching defendant, but retain the higher burden for sellers in consumer contracts. Official Comment 3 explains that the penultimate sentence was stricken for redundancy. *See id.*

<sup>82</sup>*See Stewart*, 245 S.W.2d at 486.

today avoid characterizing the extra damages as penalties. Instead they are discounts that can be reimposed upon breach. The discounts may be in overall price, or in deferred payments, or reduced interest on the underlying financial agreement. How does the current crop of consumer incentives fare, and specifically for the hypothetical in this article, how does the rent discount fare?

#### A. The Rent Concession

The problem involving the Martin family, stated at the outset of this article, the lease provided these pertinent points: The lease stated in clause 6 that tenant “will pay \$975.00 per month for rent” then stated in clause 10 that “Resident will receive \$200 monthly discount making monthly rental rate \$775.00.” A lease addendum entitled “Rent Concession and Discount Addendum” read “A monthly recurring concession. The monthly Market Rent amount will be reduced by \$200 per month during the initial lease term making the monthly rent amount \$775. This rate reduction may or may not be offered on renewal leases.” Additional terms both in the lease and the addendum stated that if tenant moved out before the end of the lease, the concessions would be forfeited, and that if the rent was late in any given month, the concession was forfeited for that month, in addition to other late fees specified in the lease. The parties agreed to these terms, evidenced by signatures on the lease and the addendum, and by initials at the bottom of each page of the lease. Pam Martin’s father signed the lease as guarantor.

##### 1. Construing the Lease

Quick conclusions are easily reached here, supporting both sides. On Pam’s side, the demand was significantly more than she had been paying in rent. Any thought on her part that she would owe a couple of months’ rent after reletting was misplaced. On the landlord’s side, Pam had not only signed a lease that spelled out these damages, she had initialed each page. Pam had breached and would now pay the clearly-specified “market rent.” Although Pam had no thought of the illegality of penalties, her resistance was well founded. That conclusion is supported by several points that initially seem to favor the landlord, but fail on a cursory legal or economic analysis.

First is the lease language in clause 6 that tenant “will pay \$975 a month,” modified by the language in clause 10 with the \$200 monthly concession, “making the monthly rent \$775.” So what is the rent—\$975 or \$775? Keeping in mind that the contract language alone does not determine this,<sup>83</sup> the most pertinent point is that tenant was in fact paying \$775 a month. The tenant was attracted to this apartment with an expectation of paying \$775 a month, in spite of the language that the rent would be \$975 a month in the event of breach.<sup>84</sup>

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<sup>83</sup>*Stewart*, 245 S.W.2d at 486.

<sup>84</sup>Closely related and undeserving of separate enumeration is the argument that the parties had an agreement. That is, however the lease’s terms can be characterized as rent or penalties, the contract is clear on the underlying point—tenants agreed to pay an extra \$2800 in the event of early termination of the fourteen-month lease. This conclusion is reached with no regard for law or history, but many consumers apparently believe it. But as with

A second point is the landlord's measure of damages. If tenant remains in the apartment for the duration of the lease, landlord would collect fourteen installments of \$775 and no more, other than perhaps incidental fees at move-out. The \$200 monthly rent concession, adding up to \$2800 for the fourteen-month term of the lease, is not a part of the performance of this contract. The landlord collects that \$2800 concession only if tenant breaches. When tenant moves out early, the landlord's out-of-pocket loss of rent is measured from a \$775 base.

A third point, tying into the second, is the penalty/liquidated damages distinction. Under American law in general and Texas law in particular, the test is *Stewart's* requirement that liquidated damages provisions be for uncertain losses and the stipulation must be reasonable.<sup>85</sup> The rent concession fails quickly here because the landlord's actual damages are readily ascertainable. The loss is the amount of rent the tenant would have paid, plus actual bills such as utilities, plus various liquidated fees for reletting and cleaning.<sup>86</sup> Whatever argument that can be made for the rent concession as a damage provision, it is not a measure of any loss suffered by the landlord.<sup>87</sup>

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other illegal aspects of contractual agreements, courts ignore penalty clauses. The fact that the parties have agreed is irrelevant. Had the parties not agreed, it would not be a contracted-for penalty. If this argument had any validity, then courts and legislatures would lack power to impose terms on contracting parties, or to declare public policy in regard to contracts. The opposite is true, and that truth extends far outside the single point of contract penalties. *E.g.*, *Stewart*, 245 S.W.2d at 486 ("Regardless of which line of cases is followed, the courts will not be bound by the language of the parties."). *See generally* II FARNSWORTH, *supra* note 6 at §§5.1-5.9, pp. 1-100. *See also* Joseph Story's quote, *supra* note 43 and accompanying text.

<sup>85</sup>*Stewart*, 245 S.W.2d at 486.

<sup>86</sup>Most of these contractually-specified damages are uncontroversial, though they may be onerous to the breaching tenant. Other than the rent concession, the other fees are assessments of actual loss to the landlord. Ordinary rent, utilities, repair and clean-up are out-of-pocket losses to the lessor. The reletting fee is not necessarily an measured out-of-pocket loss, but is a valid assessment of liquidated damages. The costs of reletting the premises include advertising and the salaries of employees who answer the phone and show the apartment. Large apartment complexes with continual turnover will bear these costs in any event, merely to promote full occupancy, and without regard to how many tenants left early. While breaching tenants may increase the work for employees, they likely have little impact on the advertising costs for large apartment complexes. Nevertheless, it is fair to spread those costs to the tenants who leave early. The costs, of course, will vary from breach to breach, and while \$824 may seem high, it is an assessment of an actual cost to the lessor. As long as courts find it reasonable, it is appropriate liquidated damages under *Stewart*.

<sup>87</sup>Two arguments for the rent concession as liquidated damages come to mind, and both are flawed. The first is that the rent concession is liquidated damages for an unoccupied apartment and the accompanying blight. It is doubtful that the law imposes a duty on tenants to remain in a residence on that basis and there is no precedent to support this. To the extent that this duty-to-occupy has any validity, Pam's form lease did not address this issue. To the contrary, the lease allowed the tenant to abandon the apartment and live elsewhere as long as the rent was paid. The second argument for the rent concession as liquidated damages is that the \$200 monthly concession is a late fee. In support of this, Pam's lease states that the concession is forfeited, for that month only, if the rent is late. That provision, however, is in addition to a standard liquidated damages provision regarding late rent that imposes a late fee of \$50 and \$5 a day until the rent is paid. Assuming no ambiguity here, is the extra \$200 an additional late fee or merely part of the rent? As discussed in the prior paragraph, the rent is \$775 a month except in the event of breach. The breach, in this case a nominal breach for late rent, kicks in \$200 additional rent, and does so in addition to the

A fourth point goes to the underlying policy behind the centuries-old ban on contract penalties. The lease's penalty clause entitles the landlord to all \$2800 whether the tenant moves out one month early or eleven months early. The value of the contract to the landlord increases by \$2800 in the event of breach. Admittedly, landlords often do not collect from breaching tenants and the extra \$2800 may be nothing more than a paper victory. But that paper victory can be powerful in the hands of aggressive collection agencies and credit reporting services. Although there are no demographic studies describing the victims of contract penalties, the practice is best targeted at middle class consumers who wish to protect their credit. The author's anecdotal collection of leases in the preparation of this article supports the idea that apartments leasing to a broad middle income group use this practice of rent concessions.

## 2. A Law and Economics Conundrum, and a Solution

A final point that ostensibly supports the landlord raises a deeper economic analysis and deserves a separate heading. This is the glass-half-empty/glass-half-full question. The landlord may argue that the rent concession is not a penalty at all, but is instead a bonus. That is, the lease does not impose a penalty for moving out early. It does the opposite. It rewards the tenant for not moving out. Instead of a penalty for breach, tenant merely loses the bonus.

Avery Katz is a law-and-economics specialist, and more important for this discussion, teaches contracts to law students at Columbia. He poses a similar problem to his students. First he asks them whether one can guarantee prompt performance from a building contractor by providing that late performance will result in a 20% cut in the price. The students correctly answer that such a penalty would be voidable if the party's actual damages did not reasonably support the 20% claim. Katz then asks them about cutting the price by 20%, and providing a 20% bonus for on-time performance. He reports that students usually see that simply cutting the price and re-labeling the penalty as a bonus cannot operate as an all-purpose method of evading the penalty doctrine. Katz points out, however, that the question can be more complicated because bonuses as such are legitimate and play valid roles in contract law. He proposes that the distinction between contract bonuses and penalties lies in their function, much as Judge Posner distinguishes between penalties and valid liquidated damages.<sup>88</sup> A true bonus, Katz says, rewards the performing party beyond the contract's fixed consideration for routine performance.<sup>89</sup>

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lease's provision for a typical liquidated fee for late rent. Again, it appears to be a penalty for breach.

<sup>88</sup>See *Lake River*, 769 F.2d at 1289-93.

<sup>89</sup>Email and telephone discussions with Avery Katz, July 28, 2006. Professor Katz further explains that in using market value to distinguish a bonus from a penalty, he would be careful to obtain objective measures outside the parties' viewpoints. Thus, in Pam's case he would accept neither the lease's \$975 "market rate" nor the parties' actual \$775 transaction rate, but instead would measure market value from a sufficiently large number of similar rentals where the terms did not include the rent concession or other bonus/penalty provisions. Katz points out that a problem occurs even with this objective measure if all sellers in a given market recast their penalties as bonuses; there, he would use the parties' actual transaction price to measure market value. *Id.* No public data is available as to how many apartment complexes in Texas use the Texas Apartment Association's form lease with the rent concession clause. To the extent that use is widespread, the measure of market value in Pam's case is \$775.

Even with this explanation, distinguishing a bonus from a penalty can be difficult. It is especially difficult in ad hoc contracts drawn from scratch, such as an artist's agreement to paint a portrait or a builder's agreement to construct a unique home. It becomes easier in open market consumer contracts. In that setting, the bonus/penalty distinction can be made by comparison of the contract's terms to similar agreements in a broader market. In other words, if Pam Martin's landlord claims that the \$200 concession is a bonus for an apartment renting for \$975, what would that apartment bring in a wider market sample? If the market value is \$975 as the landlord maintains, then the \$200 concession is a bonus for Pam. If the market value is \$775, then Pam has not received a bonus but instead faces a \$200 penalty for breach.

This brings up a related point in Pam Martin's lease, which used the term "market rent." Specifically, the Rent Concession and Discount Addendum states that "[t]he monthly Market Rent amount will be reduced by \$200 during the initial lease term making the monthly rent amount \$775."<sup>90</sup> The lease does not otherwise define the term "market rent," and that term cannot be found in dictionaries, including those focused on economics.

Consulting economics dictionaries and treatises does not advance the analysis much further. For economists, the terms "value" and "worth" are not precise terms of art. Economics references, if they define these terms at all, do not provide consistent meanings.<sup>91</sup> Instead, the terms are generic and mean what the speaker wants them to mean, reminiscent of Lewis Carroll's approach to meaning. With "value" and "worth" having no fixed meaning, what meaning should be given a contract in which the parties agree that (1) the market rent is \$975 a month, (2) but tenant will pay only \$775 a month, unless (3) tenant breaches, in which case tenant will pay \$975 a month?

If seller believes a good is worth \$1000 but nobody buys it, then the good is not worth \$1000. On the other hand, if a buyer believes he should pay only \$500 for a good but no seller will sell at that price, then the buyer is wrong. Although both buyer and seller in this example may validly claim that their disparate value settings are accurate for them, those conclusions have little meaning outside their subjective views. This approach to value is often called "intrinsic value."<sup>92</sup> The more objective approach is "exchange value," determined by what the good or service brings in the marketplace.<sup>93</sup> Although data are unavailable to show which meaning of value is more often used to measure damages, there will likely be little argument that exchange

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<sup>90</sup>*Rent Concession and Discount Addendum* at 1, on file with author.

<sup>91</sup>See generally DAVID W. PEARCE, ED., *THE MIT DICTIONARY OF MODERN ECONOMICS* 4<sup>th</sup> ed. (1992) (hereinafter *MIT DICTIONARY*), *passim*; WEST'S LAW AND COMMERCIAL DICTIONARY IN FIVE LANGUAGES (1985) (hereinafter *WEST'S LAW AND COMMERCIAL DICTIONARY*), *passim*; PETER NEWMAN, ED., *THE PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW* (1998) *passim*. Interestingly, the West reference does provide definitions for "market value" and related terms. The apparent reason for the more precise definition there is that "market value" is a legal term. See *WEST'S LAW AND COMMERCIAL DICTIONARY* at Vol. K-Z, pp. 726-27 (discussing definitions of "value").

<sup>92</sup>See *MIT Dictionary*, *supra* note 88 at 446-47 (discussing definitions of "value"); *WEST'S LAW AND COMMERCIAL DICTIONARY*, *supra* note 88 at Vol. K-Z, pp. 726-27 (discussing definitions of "value").

<sup>93</sup>*Id.*



value is appropriate for most contract damages. Exchange value is determined when the buyer and seller agree on a price. Of course, that value setting is true only for that one buyer and seller. Aggregate value is determined by a collection of transactions.

If we assume that the lease's reference to "market rent" refers to the average rental amount for similar apartments in a given geographic market, this raises an interesting question. Can we believe that the landlord willingly rents an apartment to Pam for \$775 if it will readily rent for \$975? One argument is that the seller has the option of selling (or renting) at a lower price and may do so for reasons other than maximizing profit. Such motives may occur with individual landlords renting single apartments, but are far less likely in large apartment complexes managed by an agent rather than the owner. The not-interested-in-profits motive can also be tested by measuring the frequency of rent concessions. How often does the landlord grant one? No data are available on this, but it is significant that the rent-concession language is printed on a form lease prepared by the Texas Apartment Association. As noted above, the author's inquiry resulted in numerous instances of leases with rent discounts, all reimposable. It is highly unlikely that Pam's landlord made a concession limited to Pam or a few other tenants. The practice appears to be widespread, and there are two plausible reasons for the practice—puffery and penalties. As for puffery, rent concessions are a handy marketing pitch. "This apartment is worth \$1000 a month, and if you move in this month, you'll pay only \$800." A more familiar example is the car dealer who advertises the "list price" as \$20,000 but sells the car for \$16,000. This differs from the Martin facts if the car sale does not involve the buyer's agreement to pay the list price in the event of breach, but the puffery is the same for both the landlord and the car dealer. In both cases the puffery, as such, is legal. The penalty function is illegal. Neither the lease nor the car dealer's purchase agreement can require the higher amount—the market rent or list price—upon breach.

Reliable data is available to support these market determinations in specific cases. The market value of rental properties can be determined at any given time with data from apartment rentals in a defined area. That is not to say that rent-concession penalties can be validated by market data. To the contrary, they remain penalties because they do not reflect the landlord's actual losses. But if courts or legislatures choose to view the rent concessions as bonuses rather than penalties, the burden should rest on the landlord to prove market value when seeking damages higher than the rent being paid by the tenant.

## B. Other Examples of Reimposable Discounts

Rent concessions are a subset of the transactions using the reimposable discount. Others include appliances, furniture, cell phone agreements, home security agreements, and car sales. The discounts include prices reduced from "list", delayed payments, delayed interest, and no interest. The triggering breaches can be a fundamental breach in which the buyer fails to make any payment, but could also be as simple as a minor breach such as a payment made a few days late. That is not to say that common instances of price or interest reductions involve penalties. Those are merely incentives to purchase, and no matter how specious the argument that the buyer is receiving something "worth" more than the price, the discount is a valid sales argument. These become penalties only when the agreement provides that the breach will entitle the seller

to reimpose the discount and recover something that does not remedy seller's damages and enriches the seller beyond the transaction price.

An example of the no-interest sales pitch illustrates this. Suppose that a contract for the sale of a new television, financed by the seller, offers the buyer immediate possession with no money down and no interest or payments until January 1, 2007. An additional clause states that this discount will be forfeited if the buyer breaches by not having made the first payment by the end of the five-day grace period which runs on January 5, 2007. In other words, if the buyer's first payment reaches the seller after January 5, 2007, the buyer forfeits the no-interest clause.<sup>94</sup>

John Smith buys a television with this financing agreement on July 7, 2006. The transaction price is \$2500, and no payments are due until January 1, 2007. John takes possession of the television immediately and uses it in his home through the following December holiday season. The payment schedule is mailed to John in October. In the rush of the holiday season John overlooks the payment due on January 1. He remembers the payment by January 10 and promptly submits it. The sales and financing agreement contemplate late payments and have an appropriate liquidated damages penalty of a \$25 late fee. John also submits that fee with his late payment.

On January 15, 2007, John receives a new payment schedule with a letter explaining that his late payment breaches the financing agreement and he has forfeited the interest waiver. John will now have to pay eighteen percent interest<sup>95</sup> not only through the duration of the financing term, but will also have to pay interest from the time he took possession of the television in July, 2006. Is this a penalty?

The answer is in the no-interest sales pitch. Assuming that the seller owned the television set at the point of sale (as opposed to the manufacturer owning it), when the seller gave John possession in July 2006 with no money down and no payments due for six months, the seller had a monetary outlay, at a minimum, of the price of the television. Whether that expense was borne from the seller's own funds or from borrowed funds, that money had a cost. In an ordinary transaction where the buyer pays interest, the seller or financing company will profit by charging the buyer more than its own cost in borrowing or advancing the money. But in this example of six-months' possession with no payment, the seller is not only foregoing the profit on the financing arrangement, but is bearing the cost of advancing the television for six months with no immediate return. How one calculates this cost depends on the accounting method. If we calculate the seller's cost on the transaction price of \$2500, based on the seller foregoing its account receivable for that six months, then the cost is whatever the seller paid for interest on \$2500 for six months. If the seller uses its own funds, the cost is what the seller would have received in interest on that money for six months. A lower calculation results from defining the seller's initial outlay as the seller's own cost for the television. Assume that the seller pays \$2000 for the television it sells for \$2500. Under this second method, the seller's cost is the cost

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<sup>94</sup>This hypothetical is consistent with a form contract in the author's possession for financing the purchase of electronic appliances at a nationwide retailer.

<sup>95</sup>The financing agreement on which this hypothetical is based calls for a 26% interest rate following breach. This hypothetical uses the lower eighteen percent rate to avoid readers' speculation that the higher rate might be illegal under usury laws, which is not this article's point.

of borrowing or losing interest on that \$2000.

How this is calculated is irrelevant. The seller clearly had a cost in giving John possession of the television for six months without payment. This cost is necessarily absorbed in the transaction price.<sup>96</sup> The only possible conclusion is that it is not accurate to say that a financed transaction has no interest. There is interest on the borrowed money, no matter how it is accounted for in the sale. That interest is absorbed in the transaction, and the buyer pays it. The no-interest pitch is nothing more than that. It is a sales pitch, puffery. Because the interest cost of the deferred payment is absorbed in the sales price, the buyer is already paying interest in the payment originally agreed to. Using the fallacious no-interest sales pitch to impose an additional interest charge is nothing more than imposing a penalty for breach.

One policy behind the illegality of the contract penalty is the unjustness of the seller collecting more than its actual loss. But a additional policy underscores the need to prevent penalties—penalties for minor breaches increase the seller’s profit. As a result, sellers have an interest in making conditions ripe for breach. If it is true that business and society will function better if contract compliance is maximized, consumer penalties can have the opposite effect by rewarding the seller for the buyers’ breaches. That is, sellers make more money from a breach than from routine performance. Of course, the seller will not make more money if the buyer does not pay. That is why the seller has an interest not in promoting fundamental breaches, but in inducing minor breaches where the buyer remains in possession of the product and continues to pay, but pays at a higher price than originally contemplated. These payment deferred and no-interest contracts are the breeding ground for that illicit profit.

This is not to argue that all instances of deferred principal or interest are inherently penalties. As so many scholars and courts have pointed out, it all depends on the circumstances.<sup>97</sup> On the other hand, Professor Farnsworth’s statement comes in handy here. “A provision that simply attempts to add a sum to the injured party’s actual damages is ordinarily an obvious penalty.”<sup>98</sup> Discounting a purported established price, whether the adjective is “retail,” “list” or “market,” is a puffery device perhaps as old as commerce itself. In spite of its specious logic that the good or service is worth something other than what buyer and seller agree to, the discount sales pitch is legal and time-honored if limited to that role. But when the seller’s enticement becomes the buyer’s obligation—when puffery becomes penalty—Farnsworth’s categorical statement is on point.

### C. Why These Cases Are Not Litigated

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<sup>96</sup>In this example where the seller and financing company are the same, the cost is borne by the seller. If the seller does not finance the sale, then either the seller or the financing party must bear the cost of John’s six-month no-payment possession. Unless the finance company is lending money at no charge, the seller bears the cost. Unless the seller intends to lose money on sales, the cost of the financing agreement—the interest on the loan—is absorbed in the sales price, and at a profit.

<sup>97</sup>See III FARNSWORTH, *supra* note 6 at 305-08. See also Judge Posner’s discussion in *Lake River*, 769 F.2d at 1289-93.

<sup>98</sup>See III FARNSWORTH, *supra* note 6 at 316.

It is unlikely the Martins will bring an action to reduce or clear this debt. For Pam and any number of consumers, there are several reasons why this issue does not find its way to court. One reason is embarrassment from being in the wrong. As the collection company urged both in its correspondence to Pam's father and to the Martins' attorney, Pam breached an agreement. She signed a fourteen-month lease and moved out after five. Even without the rent-concession penalty and with the credit for reletting after two months, Pam owed the landlord about \$2400. This includes two months' rent at \$775, a liquidated reletting fee of \$824 and other fees related to the move-out. What Pam should not owe is an extra \$2800 for the reimposed "market rent" on the full fourteen months, or even a \$1400 reimposed rent concession for the seven months she lived there.

A second reason these penalties are not litigated is the consumer's belief that the law allows the penalty, or their disbelief that a corporate landlord would categorically pursue an illegal remedy. Consumers may not imagine that the written contract could include illegal elements. Whatever grouching tenants and consumers may share regarding landlords and sellers, there is something persuasive about a printed lease, not to mention the collection agency's demand letter. For Pam, the landlord's demand is consistent with the contract's language. The consumer's misplaced faith is reinforced by the near-total lack of public education on consumer issues.

A third disincentive for consumer lawsuits is the relatively small gain in the face of bigger losses. However valid this article's analysis, its implementation requires a court finding that the contract is illegal. To the extent that trial courts make literal rather than policy-oriented decisions, the consumer's relief will more likely come from an appellate court. If the Martins were to lose a lawsuit, they would owe not only the full damages but attorney fees as well. On the other hand, if the Martins win the lawsuit, their damages under state and federal law are only a few thousand dollars at best. This negative cost-benefit analysis increases when the landlord (or seller in the larger setting) drops the claim in the face of an attorney's letter, as Pam's landlord did. In Pam's case, she would be taking on litigation to erase a debt that is not being pursued at the moment, with little to win in damages. But the fact that the landlord momentarily drops the claim does not mean that Pam and her parents are off the hook. The collection business has become lucrative, with collectors now talking of "regenerating" old debts.<sup>99</sup>

This third disincentive for consumer litigation—relatively low return with high risk—should not be read as an argument that the damage calculation should change. Current laws provide a reasonable penalty and attorney fees for consumer credit violations. This point is made only to explain a likely reason for the non-litigation of common wrongs against consumers. These disincentives do not mean that the potential litigation against reimposed discounts lacks

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<sup>99</sup>“But class action lawsuits filed in Texas and Chicago claimed Unifund is chasing outdated debts. In the pending Texas case, two plaintiffs say Unifund brought their credit-card debt, freshened up the delinquency dates by a year and provided them to Experian Information Solutions, one of the nation's three big credit-rating firms.” James McNair, *Bad Debts Very, Very Good for Bill Collector of Last Resort*, CINCINNATI ENQUIRER, Sunday, Nov. 23, 2003, Bus. p. 1. See also <http://www.unifund.com/aboutunifund/history.aspx>, (“Unifund popularized the concept that long-delinquent distressed debt is regenerative.”); <http://www.unifund.com/business/debtpurchases.aspx> (“We purchase charged-off debt at all stages of default: Newly defaulted; Freshly charged-off; Post-primary; Post-secondary; Post-tertiary and beyond”).

merit. To the contrary, reimposable discount provisions have become common. The setting is ideal for a class action with both plaintiff and defendant classes.

If the consumer's litigation remedy is problematic and if these illegal penalties are now pervasive, why not resolve this legislatively? Statutes banning *ad terrorem* remedies are not likely feasible. Because of the significant gray area between valid liquidated damages and penalties, it would be difficult to draft legislation that would bar these penalties without circumventing legitimate remedies. A possible solution is to draft the statute generally, barring the recovery of contract damages beyond those actually suffered, or beyond reasonable estimates of liquidated damages. But that principle is already the law. Moreover, a principle this broad would require case specific resolution, that is, litigation. The best remedy is the one in place for four centuries—a broad common law rule echoed in specific statutes such as UCC 2-718, and with statutory exceptions where fines are appropriate.<sup>100</sup>

All this assumes the judicial and legislative review would support the no-penalty principle. What if they do not? In the current wave of anti-consumer reform, courts and legislatures could validate the use of reimposed discounts in spite of their irrelevance to any loss by the seller. Not even the economists who argue for party autonomy and the availability of negotiated penalties push for that; instead they argue merely that penalties are valid in certain agreements between parties of somewhat equal sophistication and bargaining strength.<sup>101</sup> But statutes or court rulings endorsing consumer penalties in adhesion contracts is a possibility, and arguments can be made for it. One is that penalties have an *ad terrorem* function that promotes contract compliance. So does debtor's prison, or Shakespeare's pound of flesh. How far are we willing to go?

Admittedly incarceration is a harsher penalty than Pam \$2800 rent concession. The question, then, is whether allowing consumer penalties achieves the right balance. In weighing the merits, consider that consumer penalties not only do the good of promoting contract compliance, but work the bad of giving the seller a motive to induce breach or create circumstances where breach is likely. One example is requiring the initial payment on January 1 after a six-month hiatus. Sellers may argue that they do not wish to induce breach because contract compliance is preferable to penalties that may not be collected. But with credit reporting services at work, middle-class consumers have little choice but to pay if they wish to maintain their credit. Consider also the consumer who is forced into breach by circumstance. This is the efficient breach endorsed by Anglo-American law for several hundred years, and penalties undermine it.<sup>102</sup>

The gain resulting from penalties is at the expense of an increasing consumer debt load. It produces ill effects both on the broad economy and on the individual consumers unwise or unlucky enough to breach. These ill effects are exaggerated because these disputes are not being

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<sup>100</sup>For a discussion of UCC 2-718, *see supra* note 81. For examples of statutory exceptions to the penalty rule, *see supra* notes 77-79 and accompanying text.

<sup>101</sup>*See supra* note 55.

<sup>102</sup>For a discussion of efficient breaches, *see Lake River*, 769 F.2d 1289, discussed *supra* note 53 and accompanying text. *See also Liquidated Damages, Penalties and the Just Compensation Principle*, *supra* note 55.

litigated. This echoes to a time centuries ago when breaching parties with lesser leverage had to reimburse the seller significantly more than the actual loss. Late medieval England changed that.