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Three by Posner

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If Richard Posner did not invent the term "efficient breach," he at least was its most aggressive marketer. I confess that nowadays I do not find the concept particularly useful, but that does not detract from its value. It was a catalyst, forcing scholars to consider the economic function of contract remedies. Any assessment of Judge Posner's contracts jurisprudence must acknowledge that contribution.

In this paper, I will consider three of his opinions that appear with some regularity in contracts casebooks—*Northern Indiana Public Service Company v. Carbon County Coal Company*,[1] *Empire Gas v. American Bakeries*,[2] and *Lake River v. Carborundum*.[3] To anticipate my conclusions, in the first I find his analysis and conclusions to be right (with one tiny quibble). In the second, I find his conclusion on liability correct, given the statute. I believe he could have been more aggressive on the remedy issue. Still, I cannot conclude that he was wrong. On the third, I conclude that he got the outcome wrong and made a number of other errors along the way.

I. NORTHERN INDIANA PUBLIC SERVICE CO. V. CARBON COUNTY COAL CO.[4]

In the late 1970's, Northern Indiana Public Service Company (NIPSCO) was concerned about the supply of fuel for its power plants.[5] As one element of its strategy to deal with the expected increase in the cost of fossil fuels, NIPSCO entered into a twenty-year contract with Carbon County for a fixed quantity—1.5 million tons per year—of coal.[6] The base price was $24, and by 1985 the indexed price had risen to $44. The price adjustment mechanism was asymmetrical, setting a floor (itself subject to escalation) but no ceiling. This worked reasonably well for the first few years, but when fuel prices collapsed in the early 1980's, the contract price was well above market. The Indiana public utility commission

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1. 799 F.2d 265 (7th Cir. 1986).
2. 840 F.2d 1333 (7th Cir. 1988). *See also* VICTOR P. GOLDBERG, FRAMING CONTRACT LAW 123–29 (2012) [hereinafter FRAMING]; Victor P. Goldberg, *The Lost Volume Seller: R.I.P.*, 2 CRITERION J. ON INNOVATION 205 (2017) [hereinafter *Lost Volume*].
3. 769 F.2d 1284 (7th Cir. 1985).
4. 799 F.2d 265 (7th Cir.1986).
5. *Id.* at 267.
6. *Id.*

directed NIPSCO to make a good faith effort to buy power from other utilities that would sell it power at a price lower than the cost of internal generation (so-called "economy purchase orders").[7] Because of this, NIPSCO was unable to pass the increased coal prices on to its customers. It stopped taking coal from Carbon County and sought a declaration that it be excused, invoking the force majeure clause and impossibility and frustration.[8]

Judge Posner's rejection of all the excuse arguments is spot-on. The force majeure clause would allow NIPSCO to stop taking coal "for any cause beyond [its] reasonable control . . . including but not limited to . . . orders or acts of civil . . . authority . . . which wholly or partly prevent . . . the utilizing . . . of the coal."[9] NIPSCO argued that the economy purchase orders were covered by this, but as the Judge observed, the orders did not prevent NIPSCO from using the coal; it just did not allow NIPSCO to pass the coal costs on to ratepayers. Having disposed of the force majeure clause, he then turned to the excuses recognized in the doctrine—impossibility and frustration.

He framed the matter in terms of how the parties would have assigned the risk:

> Thus the proper question in an 'impossibility' case is not whether the promisor could not have performed his undertaking but whether his nonperformance should be excused because the parties, if they had thought about the matter, would have wanted to assign the risk of the contingency that made performance impossible or uneconomical to the promisor or to the promisee; if to the latter, the promisor is excused.[10]

Since the contract had explicitly assigned the risk of price change, he concluded, the promisor would bear the risk.

I have only one quibble with his disposition of the excuse arguments—his discussion of *Krell v. Henry*,[11] the leading case of frustration. After Edward VII's appendicitis resulted in the postponement of the coronation procession, a substantial amount of litigation ensued, *Krell v. Henry* being only one of a slew of cases. Krell had rented his room to Henry for the obvious purpose of seeing the procession.[12] The price was £75, with £25 up front and the remainder due, it turned out, after the postponement.[13] Judge Posner's take: "The question was, to which party did the contract (implicitly) allocate the risk? Surely Henry had not intended to insure Krell against the possibility of the coronation's being postponed, since Krell could always relet the room, at the premium rental, for the

7. *Id.*
8. *Id.* at 268.
9. *N. Ind. Pub. Serv. Co.*, 799 F.2d at 274.
10. *Id.* at 276.
11. (1903) 2 Eng. Rep. 740 (K.B.).
12. *Id.*
13. *Id.*

coronation's new date. So, Henry was excused."[14]

I have no problem with the conclusion, but the rationale is problematic. First, there was no guarantee that the substitute procession would take the same route; even if it did, there was no reason to believe it would be as attractive. (In fact, the subsequent procession did pass by Krell's flat, but since many dignitaries chose not to return to London, the value of the viewing sites apparently fell.)[15] Second, this explanation does not account for the initial payment of £25. Since per capita income in England at the time was £45, this was not a trivial sum. Although Henry had dropped his claim for the return of his prepayment, in another of the Coronation cases, *Chandler v. Webster*,[16] the court was confronted with the question. There, the court held that the parties should be left where they were at the time of the breach.[17] Henry would not have been allowed to recover his £25 and Chandler could not recover the £100 he had already paid and was liable for the remaining amount that had been due prior to the postponement. I happen to think that the court in *Chandler* was correct, but it is clear that the ability to relet was irrelevant.[18]

Having concluded that NIPSCO should not be excused, Judge Posner then turned to the remedy. He accepted the jury verdict assessing damages.[19] This was the present value of the difference between two revenue streams—the amount Carbon County would have received had the contract been performed and the amount it would have received given the projected prices.[20] Carbon County wanted more; it asked for specific performance.[21] Judge Posner's rejection of this claim had two components. First, Carbon County claimed that if the mine were shut down third parties (workers and local merchants) would suffer.[22] He rejected the argument because the claims of third parties were irrelevant and, anyway, there was no reason to believe that awarding specific performance would result in the mine operating.[23] Second, he noted that the most efficient outcome would be to shut down the mine; awarding specific performance would not result in continued production.[24] It would simply mean giving Carbon County "bargaining

14. *N. Ind. Pub. Serv. Co.*, 799 F.2d at 277.

15. VICTOR P. GOLDBERG, RETHINKING CONTRACT LAW AND CONTRACT DESIGN 140 (2015) [hereinafter RETHINKING].

16. (1904) 1 Eng. Rep. 493 (K.B.).

17. *Id.*

18. The House of Lords eventually overturned *Chandler*, holding that if performance were frustrated there must be restitution of any prepayments. I have argued that this was a mistake—one that has unfortunately been adopted in the Restatement (Second) of Contracts. RETHINKING, *supra* note 15, at chs. 11–12.

19. *N. Ind. Pub. Serv. Co.*, 799 F.2d at 281.

20. *Id.* at 279–80.

21. *Id.* at 279.

22. *Id.*

23. "[T]he workers and merchants in Hanna assumed the risk that the coal mine would have to close down if it turned out to be uneconomical. The contract with NIPSCO did not guarantee that the mine would operate throughout the life of the contract." *Id.* at 280.

24. *N. Ind. Pub. Serv. Co.*, 799 F.2d at 279.

leverage with NIPSCO, and we can think of no reason why the law should give it such leverage."[25]

II. EMPIRE GAS V. AMERICAN BAKERIES[26]

Here, Judge Posner did a good job navigating a poorly designed statute (2-306(1)). My concern is not with the liability issue on which the case was decided. Rather, it is on the remedy phase, which received almost no attention. To be sure, counsel did not help—the issue was not raised on appeal.[27] The basic facts are well known. American Bakeries Company (ABC) operated a fleet of trucks to deliver its products. Rising gas prices in the 1970's led it to consider installing converter units in its trucks that would enable them to switch between gasoline and propane at the flip of a switch.[28] It entered into a four-year requirements contract with Empire Gas for all its propane purchases and for the conversion units as well.[29] The contract said that over the four years ABC would purchase approximately 3,000 conversion units "more or less, depending upon the requirements of Buyer."[30] The conversion units, per Posner, were supplied as an accommodation.[31] The price was $750 per unit.[32] The propane price was to be determined by a loosely worded meeting competition clause.[33]

ABC changed its collective mind for reasons unspecified and took nothing. Empire sued, invoking 2-306(1) which restricted the purchaser's freedom to take "requirements as may occur in good faith except that no quantity unreasonably disproportionate to any stated estimate . . . may be tendered or demanded."[34] That left two questions: was ABC's decision in good faith; and was zero unreasonably disproportionate to 3,000? I have argued elsewhere[35] that it was a mistake to ask both questions. If the seller wanted to constrain the buyer's discretion, there were many contractual devices available and the parties were in a better position to decide this than were the codifiers. But Judge Posner was stuck with a statute, however foolish it might be.

He argued that the statute should be interpreted asymmetrically. It would prevent the buyer from ordering too much. Conceivably, if the market price exceeded the contract price, an opportunistic buyer could order an unlimited

25. *Id.* at 279–80.

26. 840 F.2d 1333 (7th Cir. 1988). *See also* FRAMING, *supra* note 2, at 123–29; *Lost Volume*, *supra* note 2, at 205.

27. It was, as we shall see, raised at trial. The trial judge's disposition was not challenged on appeal.

28. *Empire Gas Corp.*, 840 F.2d at 1335.

29. *Id.* (explaining the contract applied only to locations where Empire had dispensing equipment).

30. *Id.*

31. *Id.* at 1337.

32. *Id.* at 1335.

33. *Empire Gas Corp.*, 840 F.2d at 1335.

34. U.C.C. § 2-306(1) (AM. LAW. INST. & UNIF. LAW COMM'N 1977).

35. FRAMING, *supra* note 2, at ch. 5.

amount of the goods, forcing the seller into bankruptcy. However, since discretion on the down side was bounded by zero, Judge Posner reasoned, the buyer's ability to behave opportunistically was limited.[36] So he was able to cut down the reach of the statute. But that still left "good faith." Good faith meant, he asserted, that the buyer had to have some valid business reason. "I changed my mind" would not be enough. Since ABC refused to offer any business reason, he concluded that it had not acted in good faith and therefore it had breached. The jury found that had it not breached, ABC would have bought 2,242 conversion units over the four years and it awarded Empire damages of $3,354,963 and with little discussion, Judge Posner approved the award.[37]

I think the liability result is unfortunate, but the problem was the statute, not the judge. Perhaps, as the dissent suggested, he could have put the burden of proof on the plaintiff to show that ABC's behavior was not in good faith or, more of a stretch, in bad faith. My concern is with the remedy, which received little attention. The only remedy issue that was argued before Judge Posner was whether Empire's expert witness was correct in assuming that because propane was so much cheaper, after the units were installed ABC would use only propane.[38] He concluded that the assumption was reasonable.[39]

The jury award had two components. It awarded $642,062 for the conversion units and $2,612,901 for the propane.[40] Where did these numbers come from? Empire's primary business was selling propane and, as Judge Posner noted, it supplied conversion units as an accommodation to its customers. Empire did not produce conversion units; it bought them in a competitive market. Why would there be any damages at all? If market conditions for conversion units hadn't changed, there should be no damages on that score. Moreover, the meeting competition clause would suggest that the market/contract price differential for propane should also be zero. So how did this happen?

The answer is that the jury treated Empire as a lost volume seller. The decision did not mention the lost volume seller (2-708(2)), nor did the briefs to the Court of Appeals. However, ABC did raise the issue at trial, but the judge rejected it:

> ABC urges that, as a matter of law, Empire failed to prove damages as a result of the alleged breach of contract, thereby mandating judgment for

36. *Empire Gas Corp.*, 840 F.2d at 1334–35.

37. *Id.* at 1341–42.

38. Judge Posner dismissed ABC's other concerns: "A great weakness of American Bakeries' case was its failure to present its own estimate of damages, in the absence of which the jury could have no idea of what adjustments to make in order to take account of American Bakeries' arguments. American Bakeries may have feared that if it put in its own estimate of damages the jury would be irresistibly attracted to that figure as a compromise. But if so, American Bakeries gambled double or nothing, as it were; and we will not relieve it of the consequences of its risky strategy." *Id.* at 1342.

39. *Id.*

40. Brief and Appendix for Defendant-Appellant at 39, Empire Gas Corp. v. Am. Bakeries Co., 840 F.2d 1333 (7th Cir. 1988) (No. 82 C 815).

> ABC. With regard to the damage award for lost profits on the sale of the conversion units, it takes the position that Empire was not entitled to lost profit damages because it failed to prove first that a contract-market formula of damages was inadequate.
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> Any plaintiff who seeks to prove that damages recoverable under § 2-708(1) will not put him in the same position as performance, should be permitted to prove lost profits under § 2-708(2). J. White & R. Summers, Handbook of the Law Under the Uniform Commercial Code, §7-11 at 279 (2d ed. 1980). In this case, Empire chose to undertake the burden of proving lost profits, Tr. 2472, and the jury concluded that it sustained its burden and accordingly made an award for lost profits on the sale of the conversion units; the conclusion was reasonable in light of the evidence.[41]

For some reason, ABC failed to pursue the matter on appeal. Doing a bit of arithmetic, this works out to $286 per conversion unit, 38% of the price. In effect, the jury found that ABC had agreed to pay $286 for the option to buy conversion units for an additional $464, units that were available in a competitive market.[42] Why, on earth, would ABC have needed to pay *any* option price, let alone the implied option price of 38%? The question was never put before Judge Posner. Should he have asked? That would be beyond what most judges would be able to do; but perhaps an exceptional judge, like Judge Posner, could have posed the question.

III. LAKE RIVER V. CARBORUNDUM[43]

The Judge did a nice job explaining why he believed that liquidated damages clauses negotiated between reasonably sophisticated business firms should be enforceable. However, he claimed to have been bound by Illinois' law.[44] The litigators framed the dispute in terms of liquidated damages versus penalty clause, and he accepted that. I don't think he should have accepted their framing

41. *Id.* at 9–11.

42. $750–$286=$464.

43. 769 F.2d 1284 (7th Cir. 1985).

44. *Id.* at 1289. On this view the refusal to enforce penalty clauses is (at best) paternalistic—and it seems odd that courts should display parental solicitude for large corporations. But however this may be, 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 of the wisdom of refusing to enforce penalty clauses against sophisticated promisors . . . continues steadfastly to insist on the distinction between penalties and liquidated damages.
Id.

since there was enough available in the record to allow for an alternative reading of the contract. I have two additional criticisms. First, he failed to recognize that there would be a different damage remedy for the actual situation and his hypothetical example of an anticipatory repudiation. Second, his distinction between this contract and a take-or-pay contract doesn't work. Analytically, there is no difference.

Lake River promised to bag and distribute Ferro Carbo, an abrasive powder produced by Carborundum.[45] The clause at the center of the controversy was a minimum quantity guarantee; Carborundum would ship to Lake River a minimum of 22,500 tons over the course of three years.[46] Because of an economic downturn in the steel industry, at the end of the three years only about 12,000 tons had been shipped.[47] Lake River asked for payment for all 22,500 tons, and Carborundum refused, arguing that this would amount to a penalty.[48] Reversing the trial judge, Judge Posner agreed that it was a penalty and limited Lake River to recovery for the contract price less the avoided costs.[49]

He went through an arithmetic example in which he hypothesized certain aspects of Lake River's costs.[50] If Lake River had bagged the minimum, he estimated that it would have expected a profit of $107,000.[51] If it only bagged 12,000 tons it would have expected a profit on the goods actually bagged of only $19,000; but if that were topped up by payment for the 22,500-ton minimum, the profit would have been $260,000, over two times what Lake River would have made had Carborundum performed.[52] He threw in a few more numerical examples, but the basic point was that for any quantity less than 22,500 tons, Lake River would have been better off than if Carborundum had performed (that is, had shipped 22,500 tons).[53] Hence, he argued, this was an unenforceable penalty clause.[54] The contrast between his freewheeling estimation of Lake River's cost structure (with no help from the litigators) and his passive acceptance of Empire Gas's damage claim is stark.

The litigators, the trial judge, and Judge Posner all ignored a crucial clause in the contract (which was in the record). Lake River promised to bag a maximum of 400 tons per week. Conceivably, Carborundum could have had Lake River bag up to 60,000 tons over the three years—almost three times the contract minimum. The contract gave Carborundum flexibility; it had the option to take up to 400 tons per week for the duration. The flexibility was valuable to Carborundum in

45. *Id.* at 1286.
46. *Id.*
47. *Id.*
48. *Lake River Corp.*, 769 F.2d at 1286.
49. *Id.* at 1292–93.
50. *Id.* at 1290–91.
51. *Id.* at 1290.
52. *Id.*
53. *Lake River Corp.*, 769 F.2d at 1291.
54. *Id.*

that it allowed it to adapt to changed market conditions. But it was costly for Lake River to provide. It had to be ready, willing, and able to bag 400 tons each and every week. If the flexibility were more valuable to Carborundum than Lake River's cost of providing it, there was room for a deal. The "price" would fall somewhere between the value to the former and the cost to the latter. I put price in quotations because the price need not be, and in fact was not, explicit. The contract and the opinion only mention one specific cost Lake River incurred in reliance on the contract—the purchase for $89,000 of a new bagging system. However, it had to maintain the capacity (including the labor force) to be prepared to receive 400 tons each and every week, lest it breach the contract.[55] Carborundum was buying flexibility; the minimum quantity clause determined the price.

Lake River had tried to argue that the damages would not be as large as Posner's calculations suggested because it had a duty to mitigate.[56] Posner rejected that argument:

> Lake River argues that it would never get as much as the formula suggests, because it would be required to mitigate its damages. This is a dubious argument on several grounds. First, mitigation of damages is a doctrine of the law of court-assessed damages, while the point of a liquidated-damages clause is to substitute party assessment; and that point is blunted, and the certainty that liquidated-damages clauses are designed to give the process of assessing damages impaired, if a defendant can force the plaintiff to take less than the damages specified in the clause, on the ground that the plaintiff could have avoided some of them.[57]

Lake River's argument would have been counter-productive if it were aimed at the actual situation—a shortfall at the end of three years. However, if instead its argument concerned mitigation after the defendant had anticipatorily repudiated the contract, it would have been correct. And that leads us to the second point. To justify his argument that the damage remedy would be ridiculously large, Judge Posner presented a hypothetical. Suppose that the contract had been breached on Day 1, he said. Lake River would be paid the entire amount (over $500,000) for doing nothing, and that would obviously be a penalty. However, that is wrong. If Carborundum had repudiated on Day 1, then Lake River would no longer have had to maintain the ability to perform—its resources would be freed for other purposes.[58] Damages would reflect Lake

55. Judge Posner's calculations of fixed and variable costs did not take account of Lake River's obligation to maintain the capacity to bag 400 tons per week.

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

57. *Id.*

58. I confess that I didn't quite see this when I first wrote about the case. *Compare* RETHINKING, *supra* note 15, at 82–83, *with* Victor P. Goldberg, *Reckoning Contract Damages: Valuation of the Contract as an*

River's ability to mitigate; if market conditions hadn't changed, damages would likely be nil (assuming Lake River had not yet purchased the $89,000 bagging machine).

Was the minimum quantity contract different from a take-or-pay contract, as Judge Posner argued? He wrote: "If, as appears not to be the case here, but would often be the case in supplying natural gas, a supplier's fixed costs were a very large fraction of his total costs, a take-or-pay clause might well be a reasonable liquidation of damages."[59] The key feature of the take-or-pay contracts is not the high fixed costs; rather, just as in the Lake River contract, the key is the benefit and cost of providing flexibility. The buyer values flexibility and the seller is willing to provide it at a cost.

In a take-or-pay contract, what happens if the buyer fails to take the minimum in a particular period? There would not be "liquidation of damages," since there would be no breach. The only breach would be the buyer's failure to pay the seller the contract price times the shortfall; the contract would remain alive. If, however, the buyer in a take-or-pay contract were to repudiate its future obligations, the remedy would not be the price times the minimum take for each of the remaining years (the "reasonable liquidation of damages"). Rather, since the seller would no longer be bound, damages would reflect the seller's ability to use the freed up resources elsewhere.[60] That is, damages would take into account the seller's mitigation.

The take-or-pay contract has multiple periods while the minimum quantity contract has but one. Analytically, there is no difference. In both instances, the buyer would be liable for the shortfall if at the end of the relevant period it had not met the minimum. If the buyer were to anticipatorily repudiate, the minimum would be neither liquidated damages nor a penalty. Damages would take into account the buyer's mitigation. If the goods could be used elsewhere, mitigation would focus on the market/contract differential. If the best response to the buyer's termination were to close the project down, then damages would compare the expected future revenue stream with the costs avoided. That, recall, was the remedy that Judge Posner approved in *NIPSCO*.[61]

Could Judge Posner have ignored the fact that the parties framed the issues in terms of liquidated damages versus penalty? The materials were there in the record, although the parties did not do a good job of highlighting them. I think that he should have, especially since he was so skeptical of the penalty clause notion to start out with. His failure to do so, I suspect, was not a matter of judicial

Asset, 75 WASH. & LEE L. REV. 301 (2018) [hereinafter *Reckoning*].

59. *Lake River Corp.*, 769 F.2d at 1292.

60. The contract could have a number of bells and whistles—an early termination option, a makeup clause, a price adjustment mechanism (indexing, renegotiation, etc.)—that would complicate damage estimation. I argue elsewhere that the problem should be viewed as determining the change in the value of an asset (the contract). *See Reckoning*, *supra* note 58, at 301.

61. Of course, the NIPSCO contract was for a fixed quantity, not a take-or-pay. N. Ind. Pub. Serv. Co. v Carbon Cty. Coal Co., 799 F.2d 265, 267 (7th Cir. 1986).

restraint. Instead, it reflected his conflation of two distinct problems: a shortfall after the performance date had passed (the actual situation in *Lake River*) and a repudiation of future performance. In the former, there could be no mitigation; in the latter, damage assessment had to take mitigation into account. In neither was the liquidated damages/penalty distinction helpful.