ARTICLE

MEASURING "ACTUAL HARM" FOR THE PURPOSE OF DETERMINING THE ENFORCEABILITY OF LIQUIDATED DAMAGES CLAUSES

*Gregory Scott Crespi**

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I. INTRODUCTION

A contractual provision stipulating a sum of money to be paid as damages in the event of breach will be enforced as a valid liquidated damages clause[1] in most U.S. jurisdictions if, among

* Professor of Law, Dedman School of Law, Southern Methodist University. J.D., 1985, Yale Law School; Ph.D., 1978, University of Iowa. I would like to thank Nicole Aeschleman for her helpful comments on an earlier draft of this Article.

1. Throughout this Article, I refer to contractual provisions that provide for an agreed amount of damages for breach as "stipulated damages clauses," and I reserve the phrase "liquidated damages clause" for those stipulated damages clauses that have been

other minimal requirements that are usually satisfied,[2] it sets forth an amount that is "reasonable in the light of the anticipated or actual harm caused by the breach."[3] If the stipulated damages clause results in an award that is too large to satisfy either prong of this disjunctive "anticipated or actual harm" criterion, then the clause will be regarded as a "penalty" and denied enforcement,[4]

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determined to be enforceable.

2. These ancillary requirements are that the parties at the time of contracting anticipate difficulties in proving loss in the event of breach and that it would be inconvenient or nonfeasible for the injured party to otherwise obtain an adequate remedy. Refer to note 4 *infra*. These requirements are usually met and are not often outcome-determinative. *See* JOSEPH M. PERILLO, CALAMARI AND PERILLO ON CONTRACTS § 14.31, at 613 (5th ed. 2003) ("[N]ot many cases have appeared to turn on the criterion of uncertainty [as to possible losses resulting from breach]."). On occasion, however, stipulated damages provisions have been denied enforcement "because at the time the contract was made, it was clear that the nature of any damages which would result from a possible future breach was such that they would be easily ascertainable." Lee Oldsmobile, Inc. v. Kaiden, 363 A.2d 270, 274 (Md. Ct. Spec. App. 1976).

3. U.C.C. § 2-718(1) (2000).

> Damages for breach by either party may be liquidated in the agreement but only at an amount which is reasonable in the light of the anticipated or actual harm caused by the breach, the difficulties of proof of loss, and the inconvenience or nonfeasibility of otherwise obtaining an adequate remedy. A term fixing unreasonably large liquidated damages is void as a penalty.

Id. This U.C.C. provision has been adopted in every state except Louisiana. 1 WILLIAM D. HAWKLAND, UNIFORM COMMERCIAL CODE SERIES § 1-102:9 (repl. pp. Sept. 1998) (1982); *see also* RESTATEMENT (SECOND) OF CONTRACTS § 356(1) (1981) [hereinafter RESTATEMENT (SECOND)]. Section 356(1) was modeled directly upon U.C.C. section 2-718(1), RESTATEMENT (SECOND), *supra*, § 356 reporter's note, and it has some minor wording differences from but is substantively identical to U.C.C. section 2-718(1):

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

RESTATEMENT (SECOND), *supra*, § 356(1). *Restatement (Second)* section 356(1) is followed in some jurisdictions, but it has not been universally embraced. Some jurisdictions still apply one or another of the earlier enforceability criteria described in the text accompanying notes 7–10 *infra*. I will henceforth in this Article refer to the substantively identical U.C.C. "anticipated or actual harm" and the *Restatement (Second)* "anticipated or actual loss" phrases together as the "anticipated or actual harm" criterion, except when it is necessary or helpful to distinguish between the U.C.C. and *Restatement (Second)* formulations.

4. U.C.C. § 2-718(1) (2001); RESTATEMENT (SECOND), *supra* note 3, § 356. *But see* 2 HAWKLAND, *supra* note 3, § 2-718:2, art. 2-586-7 (repl. pp. Sept. 1998) (arguing that U.C.C. section 2-718(1) sets forth an overall "reasonableness" criterion that can be satisfied under either prong of the anticipated or actual harm disjunctive criterion).

U.C.C. section 2-718(1) appears to be intended to deny enforcement only to those stipulated damages clauses that provide for too large an award, and it does not appear to be applicable to enforceability questions that arise when the clause at issue provides for an award that is unreasonably small relative to anticipated or actual harm. *See* RESTATEMENT (SECOND), *supra* note 3, § 2-718(1) cmt. (suggesting that problems of this sort should instead be dealt with through the unconscionability doctrine). "A term fixing unreasonably large liquidated damages is expressly made void as a penalty. An and a person injured by the breach of that contract will be relegated to his other common law or statutory rights to seek damages or other remedies.

Under this disjunctive criterion, a person injured by a breach of contract therefore has two alternative means of justifying enforcement of a stipulated damages clause that meets the other applicable and minimal requirements for enforceability. He may either show that the size of the stipulated sum bears a reasonable relation to the harm anticipated by the parties at the time of contract formation as likely to result from the breach that occurred, or he may instead show that the sum bears a reasonable relation in size to the harm that actually resulted from the breach.

This anticipated or actual harm enforceability criterion was first incorporated into contract law as section 2-718(1) of the Uniform Commercial Code (U.C.C.) in the late 1950s and early 1960s and has since been incorporated more broadly into the common law to some extent, as evidenced by the substantively identical section 356(1) of the *Restatement (Second) of Contracts* ("*Restatement (Second)*"),[5] which has been embraced by some but not all jurisdictions.[6] This U.C.C. provision, and to a somewhat

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unreasonably small amount would be subject to similar criticism and might be stricken under the section on unconscionable contracts or clauses." *Id.*; *see also* RESTATEMENT (SECOND), *supra* note 3, § 356 cmt. a ("A term that fixes an unreasonably small amount as damages may be unenforceable as unconscionable. See § 208."). *But see* Naporano Assocs., L.P. v. B & P Builders, 706 A.2d 1123, 1127–29 (N.J. Super. Ct. App. Div. 1998) (applying *Restatement (Second)* section 356(1) to resolve a dispute concerning whether the sum awarded under a stipulated damages clause was unreasonably small).

> In our view, the analysis is the same [when the controversy concerns whether the stipulated damages award is too small]. The essential question is still whether the liquidated damages amount is reasonable in light of the anticipated or actual loss caused by the breach and the difficulties of proof of loss.

Id. at 1128.

5. Refer to note 3 *supra*.

6. *See, e.g.*, Nohe v. Roblyn Dev. Corp., 686 A.2d 382 (N.J. Super. Ct. App. Div. 1997) (discussing the New Jersey Supreme Court's interpretation and application of *Restatement (Second)* section 356(1)); Lind Bldg. Corp. v. Pac. Bellevue Devs., 776 P.2d 977 (Wash. Ct. App. 1989). I do not attempt in this Article to identify precisely which state jurisdictions have embraced *Restatement (Second)* section 356(1), an effort that would be made quite complicated by the fact that some courts state that they are applying section 356(1), but then proceed to apply one or another of the earlier conjunctive tests rather than the disjunctive test section 356(1) sets forth. The problem of court confusion with regard to the standards being applied may stem partly from the somewhat contradictory comment b to section 356, which first declares the disjunctive nature of the criterion unequivocally:

> The amount fixed is reasonable to the extent that it approximates the actual loss that has resulted from the particular breach, even though it may not approximate the loss that might have been anticipated under other possible breaches. . . . Furthermore, the amount fixed is reasonable to the extent that it

lesser extent the *Restatement (Second)* provision that is modeled upon it,[7] have displaced a more stringent and less consistent earlier jurisprudence under which courts either required that the stipulated sum bear a reasonable relation in size to the anticipated harm[8] or that the sum bear a reasonable relation in size to the anticipated harm and that the actual harm be greater than zero.[9] In some instances, the courts even required that the sum bear a reasonable relation in size to both anticipated *and* actual harm.[10] Initially, some judicial and academic commentators resisted the use of this more liberal disjunctive anticipated or actual harm criterion to review stipulated damages clauses for their enforceability instead of one of the earlier and more stringent alternatives,[11] but the criterion is now well-settled law for sale of goods contracts[12] and is widely, though not universally, embraced outside of that context as well.[13]

> approximates the loss anticipated at the time of the making of the contract, even though it may not approximate the actual loss.

RESTATEMENT (SECOND), *supra* note 3, § 356(1) cmt. b. But it then later states, after some less than entirely clear qualifications and caveats that appear to limit the subsequent statements to the situation in which the amount of damages is not difficult to prove, the conjunctive proposition that "if, to take an extreme case, it is clear that no loss at all has occurred, a provision fixing a substantial sum as damages is unenforceable [even if it is reasonable in relation to anticipated loss]." *Id.*

7. Refer to note 3 *supra*.

8. *See* Larry A. DiMatteo, *A Theory of Efficient Penalty: Eliminating the Law of Liquidated Damages*, 38 AM. BUS. L.J. 633, 657–59 (2001) (stating that this inquiry focused exclusively on the intent of the parties).

9. *Id*. at 659–60 (noting the contradictory nature of this approach); *see, e.g.*, Cal. & Hawaiian Sugar Co. v. Sun Ship, Inc., 794 F.2d 1433, 1436–37 (9th Cir. 1986) (applying conjunctive criteria despite the clear disjunctive language of the statute); Baker v. Int'l Record Syndicate, Inc., 812 S.W.2d 53, 55 (Tex. App.—Dallas 1991, no writ) (same).

10. DiMatteo, *supra* note 8, at 660–64 (reviewing the unenforceability of a stipulated damages clause when the clause is a reasonable estimate of anticipated harm, yet no actual harm occurred).

11. *Id*. at 667–68; *see also* Note, *Liquidated Damages and Penalties Under the Uniform Commercial Code and the Common Law: An Economic Analysis of Contract Damages*, 72 NW. U. L. REV. 1055, 1069–75 (1978). The judicial resistance often took the form of recognizing the authority of the "anticipated or actual harm" text of U.C.C. section 2-718(1) but then applying that section in a manner that overlooks the independent "actual harm" prong of the enforceability criterion, thereby replicating the earlier and more stringent judicial enforceability criteria. *See, e.g.*, Grumman Flxible Corp. v. City of Long Beach, 505 F. Supp. 623, 625–26 (E.D.N.Y. 1980); Atl. Aviation Corp. v. Provident Life & Accident Ins. Co., No. CIV. A. 86-533-CMW, 1989 WL 101469, at *6 (D. Del. Aug. 2, 1989).

12. But there still are occasional opinions, such as *Grumman Flxible* and *Atlantic Aviation*, that fail to recognize the disjunctive character of U.C.C. section 2-718(1). *See also*, *e.g.*, OWBR LLC v. Clear Channel Communications, Inc., 266 F. Supp. 2d 1214, 1226–29 (D. Haw. 2003) (stating that the "anticipated or actual loss" criterion is applicable but considering only actual losses and not anticipated losses).

13. Note, *supra* note 11, at 1074; *see also* E. ALLAN FARNSWORTH, CONTRACTS 845–46 & nn.27, 31 (3d ed. 1999) (asserting this interpretation of U.C.C. section 2-718(1) and

Under this modern disjunctive criterion, when an injured party attempts to enforce a stipulated damages provision that meets the other minimal requirements, but is too large to bear a "reasonable" relationship to the amount of harm anticipated at the time of contract formation as likely to result from breach, she must show that the sum is reasonably related in size to the actual harm caused by the breach. The sole question that I wish to address in this short Article is how the courts should interpret the "actual harm" prong of this criterion.[14] There are, of course, a number of other related issues that can arise with regard to enforcing stipulated damages clauses, but I will not consider them here.[15]

Let me narrow my focus even more to the precise issues that I wish to address. There is no question that a party injured by a breach of contract has the right under the U.C.C., where

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citing, inter alia, cases reviewing stipulated damages clauses as applied to services contracts); JOHN EDWARD MURRAY, JR., MURRAY ON CONTRACTS § 125, at 817 (4th ed. 2001) ("Numerous cases now include actual as well as anticipated loss in their statements of the rule . . . ."); Comment, *Liquidated Damages: A Comparison of the Common Law and the Uniform Commercial Code*, 45 FORDHAM L. REV. 1349, 1353 (1977) (stating that this interpretation of section 2-718(1) "seems to be generally accepted by the commentators as the intended interpretation of the drafters").

14. The U.C.C. phrase here is "actual harm"; the *Restatement (Second)* uses the substantively identical phrase "actual loss." Refer to note 3 *supra*.

15. This Article is limited in scope to the interpretation of the actual harm or actual loss prongs under U.C.C. section 2-718(1) or *Restatement (Second)* section 356(1) and it does not address any of a number of other issues related to the enforceability of stipulated damages clauses. In particular, this Article does not address the merits of the generally applied liquidated damages clause versus penalty dichotomy that denies enforcement to some mutually consensual provisions, even absent any showing of nondisclosure or unconscionability. This threshold question is extensively discussed elsewhere. *See, e.g.*, Charles J. Goetz & Robert E. Scott, *Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach*, 77 COLUM. L. REV. 554, 555 (1977) ("[A]ttempts to secure performance through *in terrorem* [a sum fixed as a deterrent to breach or as security for full performance by the promisor, not as a realistic assessment of the provable damage] clauses are currently declared unenforceable even where the evidence shows a voluntary, fairly bargained exchange."). This Article also does not consider the relative merits of the different criteria for enforceability that have been applied over the years, the issues involved in defining the "anticipated harm" or "anticipated loss" criteria under U.C.C. section 2-718(1) or *Restatement (Second)* section 356(1), or any of the issues involved in interpreting any of the enforceability criteria other than the ones here considered, except indirectly to the extent those matters are relevant to interpreting the actual harm or actual loss criteria under U.C.C. section 2-718(1) or *Restatement (Second)* section 356(1). This Article also does not address what relative magnitudes constitute a "reasonable" relation in size between a stipulated sum and the relevant measure of harm or loss or why courts have shown such difficulty understanding and such resistance to applying the disjunctive actual harm or actual loss criteria. For a discussion of many of those other issues, see generally DiMatteo, *supra* note 8, at 658–62; Note, *supra* note 11 (concluding that "the preeminence of an actual loss 'reasonableness' test . . . [may] operate 'unconsciously' within the judiciary").

applicable, and under common-law principles to seek an expectation interest-based measure of damages for his injury—an amount sufficient to put him forward into the position he would have been in had there been full performance by both parties to the contract.[16] So for the plaintiff to advance an expectation interest-based measure of the actual harm he has suffered in an attempt to enforce a stipulated damages clause is, in general, entirely appropriate.[17] However, recovery of expectation damages is universally recognized to be subject to several important, and at times severe, limitations: that they not be reasonably avoidable by the injured party,[18] that they be reasonably foreseeable by the breaching party at the time of contracting,[19] and that they be reasonably certain in amount.[20] These limitations, taken together, raise an interesting and surprisingly difficult question. Should the actual harm suffered by the plaintiff that is to be compared to the stipulated sum for the second prong of the enforceability inquiry be defined as the "raw" expectation damages that the plaintiff can demonstrate he has suffered, without regard to the avoidability, foreseeability, and certainty limitations, or should actual harm be defined as the perhaps significantly smaller sum that the plaintiff could actually obtain in a judgment in which all of those limitations were imposed on his recovery? Or should actual harm be interpreted to include some but not all of the losses that are denied recovery under one or another of those limitations?

The text of the relevant U.C.C. and *Restatement (Second)* provisions and their supporting official commentary are not alone sufficient to resolve the question. The *Restatement (Second)*'s avoidability, foreseeability, and certainty limitations each

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16. U.C.C. § 1-106(1) (2003); *see also* RESTATEMENT (SECOND), *supra* note 3, § 347. Under some circumstances a plaintiff whose theory of contract formation rests upon promissory estoppel under *Restatement (Second)* section 90 will be restricted to a reliance interest-based award. *See* Edward Yorio & Steve Thel, *The Promissory Basis of Section 90*, 101 YALE L.J. 111, 138–39 (1991) (stating that although the *Restatement (Second)* authors advocate reliance damages for promissory estoppel, reported cases often grant expectations damages instead).

17. *But see* Yorio & Thel, *supra* note 16, at 138–39 (addressing contracts formed under *Restatement (Second)* section 90).

18. RESTATEMENT (SECOND), *supra* note 3, § 350(1) ("[D]amages are not recoverable for loss that the injured party could have avoided without undue risk, burden or humiliation.").

19. *Id*. § 351(1) ("Damages are not recoverable for loss that the party in breach did not have reason to foresee as a probable result of the breach when the contract was made.").

20. *Id.* § 352 ("Damages are not recoverable for loss beyond an amount that the evidence permits to be established with reasonable certainty.").

describe when damages are "not recoverable,"[21] thereby suggesting without clearly stating that a person may suffer losses that would not be recoverable as part of an expectation interest-based judgment but presumably would still be relevant for the *Restatement (Second)*'s "actual loss" calculations when reviewing stipulated damages clauses.[22] The Comment and Reporter's Note to section 356 do not provide any further clarifications regarding the elements to be included in actual loss.[23] The U.C.C. is similarly ambiguous. It states at section 1-106 that consequential damages may not "be had except as specially provided,"[24] and then at section 2-715 defines consequential damages in a nonexclusive fashion to include losses that are foreseeable and not reasonably avoidable.[25] These two provisions leave uncertain whether unforeseeable or reasonably avoidable losses, although they probably should not be considered consequential damages[26] and therefore not be recoverable as part of a judgment under section 1-106, are still

21. Refer to notes 18–20 *supra*.

22. *See, e.g.*, PERILLO, *supra* note 2, § 14.13, at 614 ("The phrases 'actual harm' or 'actual loss' are ambiguous. Do they include injury not compensable as damages because of the rules of foreseeability, certainty and mitigation? There is no definitive answer."); *see also* FARNSWORTH, *supra* note 13, § 12.18, at 845 n.25 ("It is unclear whether actual loss [for U.C.C. section 2-718(1) or *Restatement (Second)* section 356 purposes] includes loss that would be excluded from damages because not foreseeable."); Joseph R. Crowley, *New York Law of Liquidated Damages Revisited*, 4 N.Y. CONTINUING LEGAL EDUC., Aug. 1966, at 74 (suggesting that the term "actual" may refer either to all harm that has occurred or only to those damages that are legally recoverable: "The difficulty exists because of the use of the adjective 'actual'"); Comment, *supra* note 13, at 1357 ("[I]t should be noted that a precise determination of what the Code drafters meant by the term 'actual harm' is unclear.").

23. Comment b to *Restatement (Second)* section 356 and illustration 2 emphasize the fundamentally disjunctive nature of the anticipated or actual loss criterion by making it clear that a stipulated damages clause that provides a sum reasonable in size in relation to the actual loss caused by the breach is enforceable, even if the sum is unreasonably large regarding the loss anticipated to result from a breach that is *different* from the breach that occurred. It does not address the situation in which the sum is unreasonably large regarding the loss that was anticipated to result from the breach that *did* occur, nor, more importantly for the question here considered, does it address the question of what elements of loss are to be included in actual loss. *See* RESTATEMENT (SECOND), *supra* note 3, § 356 cmt. b, illus. 2. The reporter's note to that section is also unhelpful because it merely describes the case law underlying illustration 2 and provides some additional citations regarding the proposition presented by that illustration. *See id.* § 356 reporter's note, cmt. b.

24. U.C.C. § 1-106(1) (2003).

25. *Id.* § 2-715(2).

26. U.C.C. § 2-715(2) states in nonexclusive fashion that consequential damages "include" foreseeable and not reasonably avoidable losses and does not state that they "only include" such items, thus at least leaving open the (rather implausible) possibility for a broad interpretation of the consequential damages definition that includes also unforeseeable or avoidable losses, or both. *Id.*

properly considered part of the injured person's actual harm calculation for section 2-718(1) stipulated damages clause review purposes.[27] The usually very comprehensive U.C.C. treatise by James J. White and Robert S. Summers has only very brief references to U.C.C. section 2-718(1) and is surprisingly silent on the question of calculating actual harm.[28] The Official Comment to section 2-718 provides no assistance, stating only that "subsection [2-718(1)] sets forth explicitly the elements to be considered in determining the reasonableness of a liquidated damage clause" and failing to more specifically identify the elements of actual harm.[29]

The academic commentators that have noted the existence of this problem all agree that the proper interpretation of the "actual harm" phrase with regard to nonrecoverable items of loss is not self-evident and requires a deeper inquiry.[30] Some of the major contract law and U.C.C. treatise writers, and a few other academic writers, have offered some helpful insights and suggestions regarding its interpretation, but none of them have conducted anything approaching a full inquiry.[31] The few other

27. FARNSWORTH, *supra* note 13, § 12.18, at 845 n.25; PERILLO, *supra* note 2, § 14.31, at 614–15; Crowley, *supra* note 22; Comment, *supra* note 13, at 1357. Hawkland speculates that the intent of the U.C.C. drafters may have been that actual harm should be limited to recoverable damages:

> Because it seems obvious that a liquidated damage clause that correctly forecasts the actual harm should be valid and require no further deliberation, there has been some speculation that the words "actual harm" used in subsection 2-718(1) may have a purpose other than making this point doubly certain. One possibility is that actual harm means recoverable damages so that a preestimated loss that included consequential damages too remote to be recovered would not be an accurate forecast of actual harm, and, therefore, could fail as a penalty.

2 HAWKLAND, *supra* note 3, § 2-718:2 (repl. pp. Sept. 1998).

28. JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE § 4-6, at 195 (3d ed. 1988).

29. U.C.C. § 2-718(1) cmt. 1.

30. *See, e.g.*, FARNSWORTH, *supra* note 13, § 12.18, at 845 n.25; PERILLO, *supra* note 2, § 14.31, at 614–15; Comment, *supra* note 13, at 1357.

31. For example, Joseph Perillo, in his *Calamari and Perillo on Contracts* treatise, has suggested on the authority of some very limited case law that is not exactly on point that the "actual harm" phrase should be interpreted to exclude reasonably avoidable damages, but should include damages that would not be recoverable because of the foreseeability or certainty limitations or both: "It is submitted that 'actual harm' means all harm that could not have been minimized under the mitigation principle, whether or not compensable in the absence of an agreed damages clause." PERILLO, *supra* note 2, § 14.31, at 614–15 & n.23 (citing Vanderbilt Univ. v. DiNardo, 174 F.3d 751 (6th Cir. 1999); Wassenaar v. Panos, 331 N.W.2d 357 (Wis. 1983)).

John Murray, in his well-known *Murray on Contracts* treatise, states that he understands U.C.C. section 2-718(1) and *Restatement (Second)* section 356(1) as calling for inclusion of unforeseeable damages as aspects of actual harm or actual loss for the purposes of those enforceability criteria. This, he notes, may lead to the enforcement of writers who have addressed this issue have similarly provided only limited analysis.[32] The case law applying U.C.C. section 2-781(1) or *Restatement (Second)* section 356(1), as will be discussed below, is relatively sparse and does not definitively resolve the issues raised. Courts and commentators have thus left the answer to this Article's question in a rather confused state that calls for further inquiry.

Part II of this Article offers an analysis of how the actual harm prong of the disjunctive criterion should be interpreted for the purpose of determining whether a stipulated damages clause in a contract is a valid liquidated damages clause or is instead an invalid penalty clause. It analyzes separately whether reasonably avoidable losses, uncertain losses, and unforeseeable losses should each be included as elements of actual harm. It concludes that actual harm should be interpreted to include those losses that would be recoverable in a judgment subject to the avoidability, foreseeability, and certainty limitations on recovery, plus those unforeseeable (and therefore unrecoverable) losses that were not reasonably avoidable and that are reasonably certain in amount. Those unrecoverable losses that either were reasonably avoidable or could not have been proven in amount with reasonable certainty, or both, should *not* be included as elements of actual harm.

I will incorporate into this Part II analysis, as appropriate, the existing case law addressing these issues and also offer my

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some stipulated damages clauses that may have been intended to operate as supracompensatory penalties, even though he does not favor this principle and sought unsuccessfully to have the *Restatement (Second)*'s reporter embrace a formulation of the enforceability criterion in section 356(1) that differed from that in U.C.C. section 2-718(1) in order to preclude such a result. *See* MURRAY, *supra* note 13, § 125, at 817 & n.285 (citing as further support for this interpretation of U.C.C. section 2-718(1) an article by Ellen A. Peters, *Remedies for Breach of Contract Relating to the Sale of Goods Under the Uniform Commercial Code: A Roadmap for Article Two*, 73 YALE L.J. 199, 278 (1963)).

William Hawkland, in his *Uniform Commercial Code Series* multivolume treatise, speculates—but does not definitively conclude—that the U.C.C. drafters may have intended that actual harm exclude unforeseeable losses. Refer to note 27 *supra*. Finally, Allan Farnsworth, in his *Contracts* treatise, has simply stated without elaboration or supporting authority that "it is unclear whether actual loss includes loss that would be excluded from damages because not foreseeable." FARNSWORTH, *supra* note 13, § 12.18, at 845 n.25.

32. *See, e.g.*, Comment, *supra* note 13, at 1356–58 (favoring the exclusion of avoidable damages from "actual harm" without arguing that this interpretation is mandated, arguing in favor of inclusion of unforeseeable harm in "actual damages," and stating somewhat ambiguously with regard to the reasonable certainty requirement that "there is no reason to presume that it would be a serious factor in judging actual harm"); N.Y. State Law Revision Comm'n, *Study of the Uniform Commercial Code* 581 n.468 (1955) (noting that unforeseeable losses "must be excluded from the harm caused by the breach for the purpose of determining the reasonableness of the agreement on liquidated damages" (emphasis omitted)).

assessment of this jurisprudence. The case law is relatively sparse with regard to the avoidable losses or unforeseeable losses issues, but it is in general accord with my recommendations on these questions, although it embraces what I and other commentators regard as an inappropriate rationale for excluding avoidable losses from actual harm. The case law is somewhat more extensive with regard to the issue of including uncertain losses in actual harm, and it is not in complete accord with my recommendation that such losses be excluded. Part III presents a brief overall conclusion to the Article.

II. INTERPRETING "ACTUAL HARM"

Any effort to interpret the actual harm prong of U.C.C. section 2-718(1) (or the substantively identical actual loss prong of *Restatement (Second)* section 356(1)), should start with the recognition that the disjunctive anticipated or actual harm criterion is more liberal in enforcing stipulated damages clauses than were any of the several alternative judicial tests in use prior to its widespread adoption: previous tests all required that the sum awarded bear a reasonable relation in size to anticipated harm, and some of the tests also imposed additional requirements with regard to the amount of actual harm.[33] The adoption by the U.C.C. and the *Restatement (Second)* of this new and more liberal disjunctive criterion only makes sense if the actual harm prong is construed to have some independent scope of application. Actual harm must be interpreted so that some stipulated damages clauses that do not satisfy the anticipated harm prong, and therefore would not have been enforced under any of the earlier enforceability criteria, will then satisfy the actual harm prong for enforceability. Another and perhaps more succinct way to say this is that the actual harm phrase should be interpreted in a manner so that there are possible circumstances under which actual harm would exceed anticipated harm, otherwise the actual harm prong of the criterion would be useless surplusage. Conversely, any interpretation of actual harm that necessarily limits it to no more than the amount of anticipated

33. Refer to text accompanying notes 7–13 *supra*. *See* Nohe v. Roblyn Dev. Corp., 686 A.2d 382, 385 (N.J. Super. Ct. App. Div. 1997) (quoting CUNNINGHAM ET AL., THE LAW OF PROPERTY § 10.4, at 650–51 (1984)) (pointing out that the traditional tests measured reasonableness only at the time of contract formation, destroying much of the advantage of stipulated damages clauses); PERILLO, *supra* note 2, § 14.31, at 614 (indicating that the new test will work in favor of more frequent enforceability of stipulated damages clauses).

harm should be rejected as not in accordance with the probable intent of the drafters.[34]

This simple insight is sufficient to rule out as unreasonable any former interpretation of actual harm that excluded all amounts not recoverable because of the avoidability, foreseeability, or certainty limitations. Let me explain this somewhat subtle point more fully. Those actual losses that were reasonably foreseeable to result from breach, that are reasonably certain in amount, and that are not reasonably avoidable by the injured party are among the losses that would be anticipated by the parties at the time of contracting as likely to result from breach. Put another way, one anticipates those losses that one can foresee resulting from breach, that one expects to be able to prove with reasonable certainty, and that one does not expect to be able to reasonably avoid after breach. Therefore, the foreseeable, reasonably certain, and nonavoidable loss elements of actual harm are necessarily also elements of anticipated harm, as are any foreseeable losses that did not actually result from the breach. If actual harm is interpreted to exclude all nonrecoverable losses, it will necessarily be equal to or less than anticipated harm, rendering the actual harm prong of the enforceability criterion useless surplusage.

An interesting question is whether or not those losses that one can foresee resulting from breach, but that one does not expect to be able to prove with reasonable certainty, should be regarded as an element of anticipated harm. However, the answer to this question is irrelevant for this comparison of the relative sizes of actual harm and anticipated harm if those uncertain losses are not included as an element of actual harm. This is because, as I have shown above, the amount of actual harm remaining after all reductions required by the avoidability, foreseeability, and certainty limitations have been made will necessarily be equal to or less than the amount of anticipated harm, even without the inclusion of foreseeable but uncertain losses in "anticipated harm." Therefore, if the actual harm prong is interpreted to exclude *all* nonrecoverable losses, there could never be a stipulated damages clause that did not satisfy the

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34. In complete accord with this analysis is Comment, *supra* note 13, at 1357:

> If actual harm is limited to those damages which are reasonably foreseeable at the time of the making of the contract, then there may not be a significant difference between actual harm and harm anticipated . . . . [This] interpretation of actual harm may pose a major limitation to the Code's alternative test for measuring the validity of liquidated damages clauses. This fact argues strongly against such an interpretation.

Id.

prong of being reasonable in size compared to the anticipated harm, yet did satisfy the prong of being reasonable in size compared to the actual harm. The actual harm prong interpreted this way would have no independent scope of application whatsoever. This is an obviously unreasonable and unsatisfactory interpretation of actual harm.

My conclusion is that for the actual harm prong not to be surplusage and to have an independent scope of application, it must be interpreted to include *at least* one element of loss that would not be recoverable in a judgment because of the avoidability, certainty, or foreseeability limitations. However, it need not necessarily be interpreted to include more than one of these nonrecoverable elements of harm to accomplish this objective. I will now consider in turn each of these potential inclusions.

A. Avoidable Losses as an Element of "Actual Harm"

I begin with the question of whether reasonably avoidable damages should be included as an element of actual harm or actual loss. It seems immediately clear that this cannot have been the intent of the drafters, because the inclusion of those damages in actual harm or actual loss when reviewing enforceability would create perverse incentives for the injured party that could encourage economic waste.

For a particular plaintiff who is attempting to enforce a stipulated damages clause through invocation of the actual harm prong, the larger the amount of actual harm that he can claim to have suffered the more likely it would be that the court would find that the stipulated sum bears a reasonable relation in size to that actual harm. If reasonably avoidable damages could be included as elements of actual harm, a plaintiff who refused to take reasonable, cost-effective measures after breach to mitigate his damages would thereby increase his actual harm and improve his prospects for enforcement of the stipulated damages clause. A clause that stipulated a damages sum significantly larger than the amount of losses that were not reasonably avoidable might still be enforced if this sum was reasonably related to the amount of actual harm once the avoidable losses were included in that measure. A plaintiff who deliberately failed to mitigate damages in order to increase his actual harm might thereby be able to recover under a stipulated damages clause a larger additional amount—as compared to a common law expectation damages award—than the increased damages that he suffered because of his failure to mitigate.

It simply cannot have been the intent of the drafters of U.C.C. section 2-718(1) or *Restatement (Second)* section 356(1) to create such a perverse incentive on the part of injured parties to allow economic waste to occur in order to better position themselves to enforce supracompensatory stipulated damages provisions and thereby recover larger net amounts. I therefore conclude that actual harm should be interpreted *not* to include those actual losses that would be nonrecoverable because they were reasonably avoidable. I am not alone here; none of the other academic commentators that have addressed this question have called for inclusion of avoidable losses in actual harm,[35] although only Professor Perillo expressly addresses this point.[36]

Let me now turn to the case law regarding the inclusion of avoidable losses in actual harm or actual loss. First, as a general matter, let me note that the case law interpreting the actual harm prong of U.C.C. section 2-718(1) or the actual loss prong of *Restatement (Second)* section 356(1) is surprisingly sparse with regard to any of the issues I address in this Article. There are only a few cases directly on point and only a small group of other cases that are even tangentially relevant to the issues here considered.

An early decision interpreting the actual harm phrase in U.C.C. section 2-718(1) that has (unfortunately, in my opinion) come to be regarded as the leading case on point is *Equitable Lumber Corp. v. IPA Land Development Corp*.[37] That opinion specifically addresses the question of how to treat avoidable losses in the enforceability inquiry.[38] The sale of goods contract at issue in that case contained a stipulated damages clause that provided for recovery of a specific amount of attorney's fees by the seller in the event of a buyer breach that was equal to thirty percent of the amount otherwise recoverable by the seller.[39] The New York Court of Appeals importantly recognized in its analysis that the anticipated or actual harm criterion was a disjunctive test that could be satisfied if the stipulated amount bore a reasonable relation to the seller's actual attorney's fees.[40] However, the court reached the conclusion that even if the actual harm prong of this criterion was met by the clause at issue, it

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35. Refer to note 31 *supra* (summarizing the views of the authors of several well-known treatises).

36. Refer to note 31 *supra*.

37. 344 N.E.2d 391 (N.Y. 1976).

38. *Id*. at 393, 397.

39. *Id*. at 393.

40. *Id*. at 395 & n.4.

still would not be enforced unless it also met what the court regarded as an independent and more stringent second reasonableness requirement imposed by the last sentence of section 2-718(1)[41]: "A term fixing unreasonably large liquidated damages is void as a penalty."[42] The court then remanded the case for a determination of whether the thirty percent fee arrangement that had subsequently been entered into by the seller was "unreasonably large."[43]

I believe that the *Equitable Lumber* court badly misread U.C.C. section 2-718(1). The final sentence of section 2-718(1) simply restates and clarifies the point made by the first sentence that a stipulated damages clause that meets all of the other ancillary requirements for enforceability will be upheld if it is reasonable in size in relation to anticipated or actual harm, and does so by stating the complementary and logically entailed proposition that if the stipulated sum is unreasonably large in size the clause will not be enforced.[44] Section 2-718(1) need not and should not be read as a prolix statute that simultaneously sets forth two different and overlapping reasonableness standards that both must be met by the relationship between the stipulated sum and anticipated or actual harm.

The practical effect of the *Equitable Lumber* ruling is that it imposes under the rubric of a reasonableness limitation an avoidability limitation on attorney's fees—and presumably on all other losses as well—before those losses are included in the actual harm prong by which the enforceability of the stipulated damages clause at issue is to be assessed. As discussed above,[45] I agree fully with this result, but the exclusion of avoidable damages from the comparison could have been much more straightforwardly justified by the *Equitable Lumber* court under the terms of U.C.C. section 2-718(1). The court should have simply made it clear that avoidable damages do not constitute

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41. "However, even if the 'actual harm' test is satisfied, it is then necessary, pursuant to the second sentence of subdivision (1) of section 2-718, to determine whether the liquidated damages provision is so unreasonably large as to be void as a penalty." *Id*. at 397.

42. U.C.C. § 2-718(1) (2003).

43. *Equitable Lumber*, 344 N.E.2d at 397.

44. Also logically entailed by the first sentence of U.C.C. section 2-718(1), though unstated and apparently not intended by the drafters, is the proposition that if the stipulated sum is unreasonably *small* in size relative to anticipated or actual harm, then it will also not be enforced under that section. *See* U.C.C. § 2-718(1) cmt. 1 (indicating the drafters' intent that such a clause would be subject to enforceability review under the unconscionability section).

45. Refer to Part II.A *supra* (suggesting that the intent of the drafters could not have been to include avoidable losses).

elements of actual harm, rather than take the more convoluted approach of first not imposing such an avoidability limitation on actual harm and then imposing, on the basis of a dubious reading of the second sentence of section 2-718(1), a second and more stringent reasonableness limitation that would serve to exclude avoidable losses from the measure of loss used for comparison.[46]

Despite this rather obviously flawed reading of section 2-718(1), the rationale of the *Equitable Lumber* decision has been followed by some later courts.[47] However, I am not aware of any judicial opinions that have set forth an independent justification for the exclusion of avoidable losses from actual harm or actual loss or that have argued for inclusion of avoidable losses in either of those criteria.

B. Uncertain Losses as an Element of "Actual Harm"

Obviously, one of the main reasons that stipulated damages clauses are included in contracts is that one or both of the parties to the contract anticipate difficulties with proving losses, in the event of breach, with the requisite degree of certainty. To deny legal effect to these stipulated damages clauses whenever this anticipated problem of proof of loss later arose would often frustrate the parties' intentions in agreeing to such a clause and thereby greatly undercut the utility of such clauses. However, under those circumstances in which the stipulated damages clause was negotiated partially or wholly in anticipation of proof of loss difficulties, the party seeking to enforce the clause should initially attempt to justify it as reasonable under the anticipated harm or anticipated loss prong of the enforceability criterion, rather than under the alternative actual harm or actual loss prong. But the extent to which courts should interpret the anticipated harm or anticipated loss criterion liberally to include losses that are foreseeable but prove to be uncertain in amount is outside the scope of this Article, which addresses only the interpretation of the alternative actual harm or actual loss prong of the criterion.

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46. In full accord with my approval of the result reached and with my criticism of the *Equitable Lumber* interpretation of U.C.C. section 2-718(1) is Comment, *supra* note 13, at 1355–56 (arguing that the second limitation is not supported by the statute itself). Also in accord with my criticism of this interpretation of U.C.C. section 2-718(1) is 2 HAWKLAND, *supra* note 3, § 2-718:5 (repl. pp. Sept. 1998): "[The *Equitable Lumber* interpretation of U.C.C. section 2-718(1)] seems unjustified. The second sentence of subsection 2-718(1) comes into play only after the court has already found the liquidated damage clause to have fixed an unreasonably large amount; it is not a sentence to be used in making that finding."

47. *See, e.g.*, N. Bloom & Son (Antiques) Ltd. v. Skelly, 673 F. Supp. 1260, 1268 (S.D.N.Y. 1987).

It would create obvious and severe difficulties to attempt to include as an element of actual harm those alleged actual losses that could not be proven in amount with reasonable certainty. To include as an element of actual harm any amount of loss that the plaintiff simply alleged that he had suffered, without requiring any supporting proof of the amount of injury, would be tantamount to removing altogether the limitation on the enforceability of stipulated damages clauses. This could not have been the intent of the drafters of the anticipated or actual harm criterion, or they would have used a different formulation that much more clearly directed this result. Some screening of alleged losses and disqualification of those that are unduly speculative from inclusion as elements of actual harm is necessary. However, the losses at issue here are by definition ones for which the plaintiff cannot meet the reasonably certain threshold of proof, so this conventional standard for screening out unduly speculative injuries cannot be utilized. To determine which of those losses that cannot be proven with reasonable certainty nevertheless have sufficient credibility to be included as an element of actual harm, it would be necessary to apply a new, intermediate standard of proof that was less demanding than the conventional reasonably certain standard, yet still rigorous enough to screen out those wholly unsubstantiated and speculative allegations of loss. However, I find it difficult to see exactly where a meaningful "somewhat less than reasonably certain" line could be drawn within the zone bounded at the upper extreme by injuries just barely meeting the reasonably certain requirement and at the lower extreme by the "no evidence at all of the amount of injury" situations, especially given the narrowness of this zone because of the very minimal "reasonably certain" showing called for by the U.C.C.[48]

There is no indication of which I am aware that the drafters of U.C.C. section 2-718(1) or *Restatement (Second)* section 356(1) intended the actual harm or actual loss provisions to require the judicial development of such delicate and dubious intermediate standards of certainty for their application. My conclusion, which admittedly conflicts with the position taken by Joseph Perillo in his well-known *Calamari and Perillo on Contracts* treatise,[49] is that actual harm and actual loss should be interpreted *not* to include losses that the plaintiff cannot prove

48. *See* U.C.C. § 1-106, cmt. 1 ("[Damages] have to be proved with whatever definiteness and accuracy the facts permit, but no more."); *see also* U.C.C. § 2-715, cmt. 4 ("Loss may be determined in any manner which is reasonable under the circumstances.").

49. Refer to note 31 *supra*.

with reasonable certainty with regard to their amount. Plaintiffs should be limited to arguing that their losses that are uncertain in amount nevertheless merit consideration under the enforceability criterion as elements of the anticipated harm or anticipated loss prong, an issue I do not address in this Article.

The body of case law that addresses the question of the inclusion of uncertain losses in actual harm or actual loss is much more extensive than the case law respecting either the avoidable loss or unforeseeable loss issues and is not entirely supportive of my preferred interpretation, which excludes such losses. Let me briefly summarize and discuss these cases.

Kvassay v. Murray[50] is a sale of goods case that sheds some light on the "actual harm" phrase as applied to uncertain losses. In that case the Court of Appeals of Kansas had a chance to opine in dicta on whether the actual harm prong of U.C.C. section 2-718(1) properly included uncertain losses, but it did not do so. The stipulated damages clause at issue provided for a sum that was determined at trial to be unreasonably large in relation to the losses that the parties anticipated at the time of contracting would result from breach.[51] The plaintiff did not attempt at trial to justify the clause on the basis of the reasonableness in size of stipulated damages in relation to his actual losses, which were of the nature of lost prospective profits for a new business venture, and the clause was therefore ruled unenforceable.[52] However, the trial court had ruled that these lost profits were too speculative and uncertain as a matter of law to be recoverable or to allow evidence to be presented to the jury concerning their amount.[53] The court of appeals consequently noted that if the plaintiff had attempted to introduce evidence of the (unrecoverable as a matter of law) lost profits solely for purposes of the section 2-718(1) actual harm calculation, "it is questionable whether the court would have permitted evidence concerning lost profits at the bench trial."[54] This statement is certainly ambiguous with regard to the court's evaluation of the lower court's admissibility ruling, but it suggests to me that the court of appeals was of the view that if the plaintiff had attempted to introduce evidence concerning the size of his losses for this limited purpose, he should have been permitted to do so, or that at least the court was not clear how the matter should then have been resolved.

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50. 808 P.2d 896 (Kan. Ct. App. 1991).

51. *Id*. at 900–01.

52. *Id*. at 901.

53. *Id*.

54. *Id*.

The Kansas Court of Appeals ultimately decided that the trial court had erred, both in deciding that the lost profits were nonrecoverable as a matter of law and, consequently, in excluding the offered evidence.[55] The court remanded for a new trial on that basis, as well as for other reasons.[56] The court therefore mooted the question of whether a remand would have been appropriate to allow the evidence to be introduced for the limited purpose of establishing the size of actual harm if the lost profits had been correctly determined to be nonrecoverable as a matter of law. It would have been helpful for later courts attempting to interpret the actual harm prong with regard to uncertain losses if the Kansas Court of Appeals had included some dicta in its opinion specifically addressing this question, but it unfortunately did not do so.

A recent federal case applying Iowa law, *MidAmerican Energy Co. v. Great American Insurance Co.*,[57] refused to consider uncertain losses as part of the actual loss prong of *Restatement (Second)* section 356(1).[58] In considering the defendant's summary judgment motion seeking to invalidate a stipulated damages clause, the court ruled both that it was the defendant's burden to show that the stipulated damages award was unreasonably large relative to the plaintiff's actual losses and that because those losses were uncertain in amount, they should not be included within the actual loss prong for the purpose of making a comparison.[59]

Naporano Associates, L.P. v. B & P Builders[60] involved a real estate contract not governed by the U.C.C., and the court applied *Restatement (Second)* section 356(1) to resolve a dispute concerning whether an award paid by a breaching buyer under a stipulated damages clause was unreasonably *small*.[61] The clause

55. *Id*.

56. *Id*.

57. 171 F. Supp. 2d 835 (N.D. Iowa 2001).

58. *Id*. at 849–50.

59. "Thus, because the court cannot conclude on the record before it the actual loss or damage caused by [the defendant's] breach of the contract, the court is unable to make a determination as to whether the contract's liquidated damages provision constitutes an unenforceable penalty." *Id*. at 850. The *MidAmerican* opinion can be criticized for its failure to consider whether the relationship between the stipulated award and the reasonably anticipated losses might have been sufficient to uphold the clause at issue, which is a second inquiry called for by *Restatement (Second)* section 356(1), but despite this flaw, the opinion is still valuable for its actual loss discussion.

60. 706 A.2d 1123 (N.J. Super. Ct. App. Div. 1998).

61. *Id*. at 1124. It is almost certainly an incorrect reading of *Restatement (Second)* section 356(1) to view it as applicable to disputes regarding whether a stipulated damages clause provides an unreasonably small recovery. Refer to note 4 *supra* for further discussion of this point.

at issue called for an award of $12,900, but the plaintiff seller's actual damages after subsequently reselling the property to another buyer were approximately $45,000.[62] However, the size of these damages was not established until sometime after breach when the plaintiff seller accepted a second, lower offer for the property after the first buyer's breach.[63]

After first determining that the stipulated damages award was reasonable with regard to the losses anticipated at the time of contracting, the court concluded that the award was also reasonable with regard to the actual losses resulting from the breach,[64] even though this second inquiry would not be necessary to uphold the provision under the disjunctive anticipated or actual loss provision of section 356(1). The court specifically noted that the size of the actual losses were uncertain at the time of breach, but indicated that this uncertainty served to make a stipulated damages award "not unreasonable."[65] This interesting ruling suggests that this court may have been of the view that when an injured person's loss is uncertain in amount, actual loss should be considered not as a precise sum, but instead as a range of amounts that bound the reasonably possible magnitudes of the actual injury, and that the stipulated damages clause should be upheld if the award is reasonably related in size to the upper endpoint of that range for the controversy at issue.[66]

Another case that provides some support for this "reasonable range" approach to incorporating uncertain losses into the actual loss prong of *Restatement (Second)* section 356(1) is *Balcor Pension Investors v. Wiston XXIV L.P.*,[67] in which, when conducting a section 356(1) actual loss inquiry following a loan default, the U.S. District Court for the District of Kansas made the following confident statement regarding the incorporation of uncertain losses into the inquiry:

> Although [the plaintiff's] actual losses are not yet definite, it appears to this court that upon the sale of the property,

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62. *Id*. at 1124, 1126.

63. *Id*. at 1128.

64. *Id*.

65. *Id*.

66. Although, to be candid, given the *Naporano* court's inappropriate use of *Restatement (Second)* section 356(1) rather than the unconscionability doctrine and given its unnecessary comparison of the stipulated damages provision with actual loss considering the provision's reasonable relationship to anticipated loss, I have my doubts whether the court really understood the issues well enough to have engaged in such a subtle consideration of the proper interpretation of the "actual loss" phrase as I have here suggested.

67. 170 B.R. 453 (D. Kan. 1994).

> the net loss to [the plaintiff], after deducting the proceeds of the sale and reinvesting that amount for the remainder of the loan term, would not approach the amount claimed as liquidated damages. Since the liquidated damages provision fixed an unreasonably large amount, it is unenforceable as a penalty . . . .[68]

This quote again suggests that the upper end of the reasonable range of possible losses that are anticipated to result once actual damages have been made definite by subsequent, postbreach events should be included in the actual loss prong for enforceability review purposes.

Yet another and very recent case that also suggests inclusion of at least the upper endpoints of the range of foreseeable but uncertain in amount losses in actual loss is *City of Davenport v. Shewry Corp.*[69] In that case, the Iowa Supreme Court noted that one of the City of Davenport's foreseeable losses resulting from the defendant's breach of an economic development contract would be a loss of jobs in the community and that the cost to the City of this loss would be "difficult, if not impossible, to measure."[70] However, the court then stated that the stipulated damages clause at issue was "clearly" not "unreasonable" in view of the "anticipated or actual harm" caused by the breach because of, among other possible resulting losses, "the damages resulting from loss of the anticipated jobs."[71]

This *Naporano–Balcor–City of Davenport* reasonable range approach can provide an indirect way of including some measure of uncertain losses in actual loss for enforceability review purposes. However, despite the confidence shown by the *Balcor* court in the feasibility of determining a meaningful "less than reasonably certain but not without any credible foundation" basis for establishing the endpoints of the actual loss range,[72] I remain of the view that in many instances this would present the severe if not insurmountable line-drawing problems that I have discussed above.[73]

Yet another opinion that at least suggests another way to bring uncertain losses into the actual harm prong is *Metlife Capital Financial Corp. v. Washington Avenue Associates*,[74] a case

68. *Id*. at 462.
69. 674 N.W.2d 79 (Iowa 2004).
70. *Id*. at 85.
71. *Id*. at 85–86.
72. Refer to text accompanying notes 67–68 *supra*.
73. Refer to text accompanying note 48 *supra*.
74. 732 A.2d 493 (N.J. 1999).

that involved a stipulated late payment fee in a commercial loan agreement.[75] The lower court had determined that this provision was an unenforceable penalty under *Restatement (Second)* section 356(1), but the New Jersey Supreme Court reversed this decision.[76] The thrust of the opinion is that the five percent late payment fee at issue was a reasonable estimate of anticipated loss given industry practices and statutory provisions governing the imposition of late fees for loan payments, but the language of the opinion is perhaps broad enough to suggest that when actual losses are difficult or impossible to determine with reasonable certainty, the amount of late charges that are common in the industry and that are permitted by statute can be used as proxy measures for the specific losses in question for the actual loss enforceability inquiry.[77]

This *Metlife* approach of using customary and statutorily permitted stipulated damages amounts as a proxy for uncertain losses would provide yet another means of attempting to quantify with some precision those uncertain losses for use in the actual loss enforceability review. In my view, however, this approach comes uncomfortably close to merely substituting the reasonably anticipated losses for the actual losses, and it thereby may vitiate the independent status of the actual loss prong with regard to uncertain losses.

I must concede that some of the above cases diverge to some extent from my recommended interpretation of actual harm or actual loss to exclude uncertain losses. None of these cases address this issue squarely, and I may be stretching their language a bit to find any relevant meaning. Nevertheless, several of these cases do suggest to me that the courts may be of the view that the upper endpoint of the reasonable range of uncertain losses should be included in the actual harm or actual loss figures when evaluating the enforceability of a stipulated damages clause. This approach may be workable on occasion, but

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75. *Id*. at 495.

76. *Id*. at 505.

77. *Id*. at 500.

> To require that operational costs be ascribed to each individual loan underestimates the difficulties and impracticalities involved in determining the actual damages incurred in dealing with delinquent borrowers. Because the costs are spread over an entire loan portfolio, it is difficult to identify specific damages attributable to the late payment or default of one specific borrower like [the defendant]. Due to the difficulty in assessing damages attributable to a specific late payment, courts have determined that one method to assess the reasonableness of late charges is to look at what is permitted by statute and what constitutes common practice in a competitive industry.

Id.

I have my doubts whether the endpoints of such a "reasonable range" can in general be meaningfully specified for losses that by definition cannot be proven in amount with reasonable certainty. I remain of the view that the more feasible approach here is to exclude uncertain damages altogether from the actual harm or actual loss calculations and limit the plaintiff to making arguments that uncertain losses should be included as elements of anticipated harm or anticipated loss for enforceability purposes.

C. Unforeseeable Losses as an Element of "Actual Harm"

Let me briefly summarize my argument up to this point and point out its necessary implications with regard to the treatment of unforeseeable losses. I have established that an interpretation of "actual harm" that excludes all losses that are nonrecoverable because of the avoidability, foreseeability, or certainty limitations is untenable because it would render the actual harm prong of the enforceability criterion mere surplusage with no independent scope of application. At least one of these nonrecoverable elements of loss must therefore be included within actual harm to give it effect as an independent prong. I have also established that it is most unlikely that the drafters of the actual harm prong intended that those losses that are nonrecoverable because of either the avoidability limitation or the uncertainty limitation be included within its scope. The available case law fully supports the exclusion of avoidable losses from actual harm, although, as I have noted, it reaches this result through a flawed rationale.[78] Some judicial opinions may be read broadly as suggesting that uncertain losses should be included in actual harm in some manner, but as I have argued, this appears to be an unworkable approach.

If one agrees that avoidable or uncertain losses should not be included in actual harm, this leaves only unforeseeable losses to consider. For the actual harm prong to have a meaningful scope of application, as discussed above, *some* nonrecoverable element of loss must be included within its scope. Therefore, at least some kinds of losses that are not recoverable because they were not foreseeable at the time of contracting should nevertheless be *included* within actual harm.

I have not located any cases that are directly on point with regard to the inclusion of unforeseeable losses in actual harm or

78. Refer to text accompanying notes 37–47 *supra*.

actual loss. There are two cases, *Wassenaar v. Panos*[79] and *Vanderbilt University v. DiNardo*,[80] that do not deal precisely with interpretation of the "actual harm" or "actual loss" phrases but that have each been cited by Professor Perillo in his treatise as providing support for his conclusion that the proper interpretation of these phrases with regard to either uncertain or unforeseeable losses is that they be included,[81] so I will briefly discuss each of these cases below.

The *Wassenaar* case arose under common law rather than under the U.C.C.[82] The employment contract at issue included a stipulated damages clause applicable in favor of the employee if the employer terminated the contract prior to its expiration date.[83] The Wisconsin Supreme Court purported to apply the *Restatement (Second)* section 356(1) anticipated or actual loss criterion to the case.[84] However, the court did not show a clear understanding of this criterion, failing to distinguish in its analysis between anticipated harm and actual harm.[85] After determining that the stipulated damages bore a reasonable relation to anticipated harm, the court nevertheless conducted an actual harm comparison analysis as though the criterion was conjunctive rather than disjunctive in nature.[86]

The *Wassenaar* court to its credit did recognize that there is potentially a difference between the actual harm suffered by a person and the amount of damages that would be recoverable in a judgment and that this fact merited some sort of consideration in a stipulated damages clause enforceability inquiry. The court stated,

> The standard calculation of damages after breach, however, may not reflect the actual harm suffered because of the breach. . . . [A]ctual harm suffered and damages that would be awarded in a legal action for breach of contract may not be the same. Nevertheless, in providing for stipulated

79. 331 N.W.2d 357 (Wis. 1983).

80. 174 F.3d 751 (6th Cir. 1999).

81. *See* PERILLO, *supra* note 2, at 614–15 (explaining that "'actual harm' or 'actual loss' are ambiguous" terms, but suggesting that actual harm should include all damages except avoidable damages).

82. *Wassenaar*, 331 N.W.2d at 361–62 & nn.7–9 (quoting the liquidated damages provisions from both the U.C.C. and the *Restatement (Second)*, but deriving the reasonableness test from common law).

83. *Id*. at 359 (describing the damages awardable to the employee should the employer prematurely terminate the contract).

84. *Id*. at 361–62.

85. *Id*. at 366–67.

86. *Id*. at 367 (concluding that in light of the actual harm, the employer failed to prove that the stipulated damages clause constituted a penalty).

> damages, the parties to the contract could anticipate the types of damages not usually awarded by law. The usual arguments against allowing recovery for consequential damages—that they are not foreseeable and that no dollar value can be set by a court—fail when the parties foresee the possibility of such harm and agree on an estimated amount.[87]

The gist of this statement is that an unforeseeable and uncertain loss, even though not a recoverable item in a damages judgment, should properly be considered under the anticipated harm prong of the *Restatement (Second)* section 356(1) criterion for enforceability of a stipulated damages clause. The opinion does not explicitly address the actual harm prong of the criterion, and the quote above does not seem to necessarily imply or even clearly suggest that unforeseeable and uncertain losses should also be included within actual harm should that second enforceability inquiry prove necessary. As I have noted, however, Professor Perillo has cited this case for exactly that proposition.[88]

Vanderbilt University is a second and more recent case cited by Professor Perillo as support for including both unforeseeable and uncertain losses within actual harm. *Vanderbilt* is another common law employment contract case, one in which the university employer sought to enforce a stipulated damages provision against its employee football coach who breached his contract.[89] The Court of Appeals for the Sixth Circuit did not reference *Restatement (Second)* section 356(1) in its opinion, apparently determining that under the applicable Tennessee law the earlier conjunctive "anticipated and actual harm" criterion still applied.[90] It then ruled that the stipulated sum was "reasonable in relation to the amount of damages that could be expected to result from the breach."[91] The court upheld and endorsed the rationale of the lower court's ruling in favor of the employer, which it understood to be based on the premise "that parties to a contract may include consequential damages and even damages not usually awarded by law in a liquidated

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87. *Id*. at 365–66 (footnote omitted).

88. Refer to note 81 *supra* and accompanying text.

89. Vanderbilt Univ. v. DiNardo, 174 F.3d 751, 753–54 (6th Cir. 1999) (quoting the text of DiNardo's liquidated damages provision).

90. "In Tennessee, a provision will be considered one for liquidated damages, rather than a penalty, if it is reasonable in relation to the anticipated damages for breach, measured prospectively at the time the contract was entered into, and not grossly disproportionate to the actual damages." *Id*. at 755.

91. *Id*. at 756.

damage provision provided that they were contemplated by the parties."[92]

I understand this quoted language from *Vanderbilt University* as endorsing the inclusion of nonrecoverable (because uncertain in amount) items of loss, if they are foreseeable, in anticipated loss for the purpose of assessing the enforceability of a stipulated damages clause. Unlike Professor Perillo, however, I am not sure that this opinion is even tangentially supportive of including uncertain losses within the actual loss prong of *Restatement (Second)* section 356(1). First, this provision was not even applicable to this case. Second, the entire focus of the Sixth Circuit's discussion is on the parties' estimation of the anticipated consequences of breach, rather than on the size of the actual resulting consequences. The opinion certainly does not support the inclusion of those uncertain losses that are also unforeseeable in actual loss, as Professor Perillo strongly suggests.[93]

D. Summary

My overall conclusion is that actual harm should be interpreted to include those losses that would be recoverable in a damages judgment that was subject to the avoidability, foreseeability, and certainty limitations on recovery, plus those unforeseeable (and therefore unrecoverable) losses that were not reasonably avoidable and are reasonably certain in amount. Those unrecoverable losses that were either reasonably avoidable or cannot be proven in amount with reasonable certainty, or both, should *not* be included as elements of actual harm.

This conclusion differs in some significant ways from the positions that have been rather summarily asserted by the prior commentators.[94] Joseph Perillo agrees that avoidable losses should not be included and that unforeseeable losses should be included, but he would also include those losses in actual harm that cannot be proven with reasonable certainty, though he does not suggest how to measure the size of such uncertain losses.[95] John Murray in his *Murray on Contracts* treatise agrees that unforeseeable losses should be included, though he would change this enforceability criterion were he able to do so.[96] He does not,

92. *Id*. at 755–56.

93. *See* PERILLO, *supra* note 2, § 14.31, at 614–15.

94. Refer to note 31 *supra* (contrasting the views of Perillo, Murray, Hawkland, and Farnsworth).

95. PERILLO, *supra* note 2, § 14.31, at 614–15 & n.23.

96. MURRAY, *supra* note 13, § 125, at 817 & n.285.

however, address the status of avoidable or uncertain losses.[97] William Hawkland in his multivolume *Uniform Commercial Code* suggests that actual harm should be understood to exclude unforeseeable losses, but he also does not address the status of avoidable or uncertain losses.[98] Finally, Alan Farnsworth in his ubiquitous *Contracts* treatise merely opines that proper treatment of unforeseeable losses under the actual harm prong is "unclear," and he similarly does not address the status of avoidable or uncertain losses.[99]

None of the cases that I discussed in Part II directly reject my interpretation of the proper scope of actual harm or actual loss, and although some of them at least suggest some difference of interpretation with regard to the treatment of uncertain losses, they do not convince me to adopt those suggestions. The prominent *Equitable Lumber* case reaches what I regard as the correct conclusion regarding the exclusion of avoidable damages from the actual harm prong by which the enforceability of a stipulated damages clause may upon occasion be assessed, but it does so through what I and the other commentators who have considered this point regard as an awkward and incorrect reading of U.C.C. section 2-718(1).[100] None of the other cases that I have discussed suggest that avoidable losses should be included in actual harm or actual loss, and I remain convinced that they should not be included.

With regard to including unforeseeable losses in actual harm or actual loss, which I favor,[101] only the *Wassenaar* and *Vanderbilt University* cases even tangentially address this question, and to the extent that they do so, they agree with me and with most other commentators[102] that these losses should be included in actual harm and actual loss.

With regard to including uncertain losses in actual harm or actual loss, which I do not favor, some of the cases discussed above are in full accord with my view, but some others can be read broadly as suggesting that the upper endpoint of some "reasonable range" for the magnitude of uncertain losses should be included in the criteria. As discussed above, I regard such an

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97. *Id*.

98. 2 HAWKLAND, *supra* note 3, § 2-718:2 (repl. pp. Sept. 1998).

99. FARNSWORTH, *supra* note 13, at 845 n.25.

100. Refer to note 46 *supra*.

101. Refer to Part II.C *supra*.

102. Refer to note 31 *supra* (concluding that Perillo and Murray agree that unforeseeable damages should be included, but acknowledging that Hawkland and Farnsworth were not certain).

approach as difficult to apply and perhaps even completely unworkable.

III. CONCLUSION

U.C.C. section 2-718(1), and the *Restatement (Second)* section 356(1) that was modeled upon it, set forth a new disjunctive enforceability criterion for stipulated damages clauses that is more liberal than were any of the prior enforceability criteria. This new criterion upon occasion requires courts to interpret the actual harm or actual loss phrases and, in particular, may at times require them to determine whether nonrecoverable unforeseeable losses, uncertain losses, or avoidable losses should be included within their scope.

The text of these provisions and their official commentary are not alone sufficient to resolve these questions, and the major treatise writers and other academic commentators have not addressed them in any depth. On the basis of the analysis presented in Part II of this Article, I have concluded that "actual harm" and "actual loss" should each be interpreted to include those losses that would be recoverable in a damages judgment that was subject to the avoidability, foreseeability, and certainty limitations on recovery, plus those unforeseeable (and therefore unrecoverable) losses that were not reasonably avoidable and that are reasonably certain in amount. Those unrecoverable losses that were reasonably avoidable or are uncertain in amount, or both, should *not* be included as elements of actual harm. In taking this position I differ in some significant respects from the views expressed by prior academic commentators.[103]

There is only a limited body of case law available that is relevant for interpreting the "actual harm" or "actual loss" phrases in these enforceability criteria with regard to this question of the inclusion of nonrecoverable elements of loss. That case law is consistent with both my conclusion that avoidable losses should not be included in those criteria, although it embraces a different rationale than I do, and my conclusion that unforeseeable losses should be included. Although this case law is perhaps not entirely supportive of the interpretation that I advocate with regard to the exclusion of uncertain losses, none of the opinions that address this question directly reject my conclusions, and to the extent that they can be read as advancing a different interpretation than I propose, I believe they are

103. Refer to text accompanying notes 94–100 *supra*; refer also to note 31 *supra* (summarizing commentators' contrasting views).

suggesting an unworkable approach. I hope that subsequent courts that are called upon to address these interpretive issues will give my arguments serious consideration.