Chapter 28. Limitation of Remedies

28.1. Limitation of Remedies in the Context of Freedom of Contract. Under the principle of "***freedom of contract***," the parties to a contract may agree to expand or limit otherwise available remedies. However, as we will discuss in more detail below, the principle of freedom of contract is not without limitations. For example, an ***unconscionable*** limitation of a remedy is not enforceable.

28.1.1. Parties to a contract may agree to ***expand or limit remedies*** otherwise available (§ 2-719(1)(a)). For example, a pizza restaurant owner who orders a custom-built brick oven may agree to the limited remedy of repair or replacement if the oven doesn't work properly.

☑ **Purple Problem 28-1**. Section 2-709 allows a seller to sue for the purchase price in only a few situations. Can the buyer agree to a clause allowing an action for the price in circumstances other than those listed in § 2-709?

28.1.2. Parties to a contract may agree to ***expand or limit damages*** (§ 2-719(1)(a)). For example, the parties can agree to cap damages to the purchase price of the goods involved.

☑ **Purple Problem 28-2**. The various seller remedy provisions of the UCC, such as § 2-708, limit a seller's damages to direct and incidental damages; consequential damages are excluded. Under the principle of "freedom of contract," will an agreement allowing a seller to seek consequential damages be enforced?

28.1.3. Parties to a contract may agree (i) to specify how damages will be calculated, or (ii) to the ***liquidation*** of damages (§ 2-718(1)). For example, if a supplier fails to timely deliver a pre-fabricated concrete form necessary to complete construction of a bridge, the contractor and supplier can agree to liquidated damages of $500 per day of delay.

28.1.4. Parties to a contract may agree to ***expand or limit warranties*** otherwise applicable. By limiting a warranty, you, in effect, limit a remedy. For example, a dealer selling a used car may properly disclaim any and all express and implied warranties relating to the car.

28.2. Liquidated Damages Clauses. Both common law and the UCC allow the parties to determine in advance what damages are payable in the event of breach, referred to as a "liquidated damages" clause. However, limitations apply.

28.2.1. Under § 2-718(1), an agreement to liquidate damages must be ***reasonable*** in light of:

- The actual harm caused by the breach (*i.e.*, is the liquidated damages amount proportionate to the anticipated actual damages);
- The difficulties of proof of loss (*i.e.*, are damages otherwise difficult to prove); and
- The inconvenience or nonfeasability of otherwise obtaining an adequate remedy (*i.e.*, would it be difficult, due, for example, to the nature of the goods involved, court costs or the non-residency of a defendant, to pursue other remedies).

28.2.2. Section 2-718(1) provides that "a term fixing unreasonably large liquidated damages is void as a ***penalty***." This limitation protects the doctrine of ***efficient breach***, which allows, even encourages, a party to be able to deliberately breach an agreement which may no longer make economic sense to perform, as long as the breaching party pays actual (versus punitive) damages.

28.2.3. The "hindsight" problem. Many courts are troubled when the liquidated damages turn out to be unreasonable in light of the actual harm caused by the breach.

28.2.3A.0. Case: *California and Hawaiian Sugar Co. v. Sun Ship, Inc.*

The following case discusses the "hindsight" problem in liquidated damages.

C&H Sugar Co. v. Sun Ship, Inc.

United States Court of Appeals for the Ninth Circuit
1986

California and Hawaiian Sugar Co. v. Sun Ship, Inc. 794 F.2d 1433 (9th Cir. 1986)

NOONAN, Circuit Judge

BACKGROUND

~C and H is an agricultural cooperative owned by fourteen sugar plantations in Hawaii. Its business consists in transporting raw sugar-the crushed cane in the form of coarse brown crystal-to its refinery in Crockett, California. Roughly one million tons a year of sugar are harvested in Hawaii. A small portion is refined there; the bulk goes to Crockett. The refined sugar – the white stuff – is sold by C and H to groceries for home consumption and to the soft drink and cereal companies that are its industrial customers.

To conduct its business, C and H has an imperative need for assured carriage for the raw sugar from the islands. Sugar is a seasonal crop, with 70 percent of the harvest occurring between April and October, while almost nothing is harvestable during December and January. Consequently, transportation must not only be available, but seasonably available. Storage capacity in Hawaii accommodates not more than a quarter of the crop. Left stored on the ground or left unharvested, sugar suffers the loss of sucrose and goes to waste. Shipping ready and able to carry the raw sugar is a priority for C and H.

In 1979 C and H was notified that Matson Navigation Company, which had been supplying the bulk of the necessary shipping, was withdrawing its services as of January 1981. While C and H had some ships at its disposal, it found a pressing need for a large new vessel, to be in service at the height of the sugar season in 1981. It decided to commission the building of a kind of hybrid-a tug of catamaran design with two hulls and, joined to the tug, a barge with a wedge which would lock between the two pontoons of the tug, producing an "integrated tug barge." In Hawaiian, the barge and the entire vessel were each described as a Mocababoo or push boat.

C and H relied on the architectural advice of the New York firm, J.J. Henry. It solicited bids from shipyards, indicating as an essential term a "preferred

delivery date" of June 1981. It decided to accept Sun's offer to build the barge and Halter's offer to build the tug.

In the fall of 1979 C and H entered into negotiations with Sun on the precise terms of the contract. Each company was represented by a vice-president with managerial responsibility in the area of negotiation; each company had a team of negotiators; each company had the advice of counsel in drafting the agreement that was signed on November 14, 1979. This agreement was entitled "Contract for the Construction of One Oceangoing Barge for California and Hawaiian Sugar Company By Sun Ship, Inc." The "Whereas" clause of the contract identified C and H as the Purchaser, and Sun as the Contractor; it identified "one non-self-propelled oceangoing barge" as the Vessel that Purchaser was buying from Contractor. Article I provided that Contractor would deliver the Vessel on June 30, 1981. The contract price was $25,405,000.

Under Article I of the agreement, Sun was entitled to an extension of the delivery date for the usual types of force majeure and for "unavailability of the Tug to Contractor for joining to the Vessel, where it is determined that Contractor has complied with all obligations under the Interface Agreement." (The Interface Agreement, executed the same day between C and H, Sun, and Halter provided that Sun would connect the barge with the tug.) Article 17 "Delivery" provided that "the Vessel shall be offered for delivery fully and completely connected with the Tug." Article 8, "Liquidated Damages for Delay in Delivery" provided that if "Delivery of the Vessel" was not made on "the Delivery Date" of June 30, 1981, Sun would pay C and H "as per-day liquidated damages, and not as a penalty" a sum described as "a reasonable measure of the damages" – $17,000 per day.

Sun did not complete the barge until March 16, 1982. Although Sun paid C and H $17,000 per day from June 30, 1981 until January 10, 1982 [about $3.3 million], it ultimately denied liability for any damages, and this lawsuit resulted.

[From July 1, 1982 to March 15, 1982, $17,000 per day adds up to about $4.4 million in total. The net actual damages suffered by C and H were $368,000.]

ANALYSIS

~Represented by sophisticated representatives, C and H and Sun reached the agreement that $17,000 a day was the reasonable measure of the loss C and H would suffer if the barge was not ready. The anticipated damages were what might be expected if C and H could not transport the Hawaiian sugar crop at the height of the season. Those damages were clearly before both

parties. As Joe Kleschick, Sun's chief negotiator, testified, he had "a vision" of a "mountain of sugar piling up in Hawaii" - a vision that C and H conjured up in negotiating the damage clause. Given the anticipated impact on C and H's raw sugar and on C and H's ability to meet the demands of its grocery and industrial customers if the sugar could not be transported, liquidated damages of $17,000 a day were completely reasonable.

The situation as it developed was different from the anticipation. C and H was in fact able to find other shipping. The crop did not rot. The customers were not left sugarless. Sun argues that, measured by the actual damages suffered, the liquidated damages were penal.

~As a matter of law, Sun contends that the liquidated damages are unreasonably disproportionate to the net actual damages.

C and H urges on us the precedent of *Bellefonte Borough Authority v. Gateway Equipment & Supply Co.,* 442 Pa. 492, 277 A.2d 347 (1971), forfeiting a bid bond of $45,000 on the failure of a contractor to perform a municipal contract, even though the loss to the municipality was $1,000; the disproportion was 45 to 1. But that decision is not decisive here. It did not purport to apply the Uniform Commercial Code. Rules appropriate for bids to the government are sufficiently different from those applicable between private parties to prevent instant adoption of this precedent. A fuller look at relevant contract law is appropriate.

Litigation has blurred the line between a proper and a penal clause, and the distinction is "not an easy one to draw in practice." *Lake River Corp. v. Carborundum Co.,* 769 F.2d 1284, 1290 (7th Cir.1985) (per Posner, J.). But the desire of courts to avoid the enforcement of penalties should not obscure common law principles followed in Pennsylvania. Contracts are contracts because they contain enforceable promises, and absent some overriding public policy, those promises are to be enforced. "Where each of the parties is content to take the risk of its turning out in a particular way" why should one "be released from the contract, if there were no misrepresentation or other want of fair dealing?" *Ashcom v. Smith,* 2 Pen. & W. 211, 218-219 (Pa. 1830) (per Gibson, C.J.). Promising to pay damages of a fixed amount, the parties normally have a much better sense of what damages can occur. Courts must be reluctant to override their judgment. Where damages are real but difficult to prove, injustice will be done the injured party if the court substitutes the requirements of judicial proof for the parties' own informed agreement as to what is a reasonable measure of damages. Pennsylvania acknowledges that a seller is bound to pay consequential damages if the seller had reason to know of the buyer's special circumstances. *Keystone Diesel Engine Co. v. Irwin,* 411 Pa. 222, 191 A.2d 376 (1963). The liquidated damage clause here functions in

lieu of a court's determination of the consequential damages suffered by C and H….

Proof of this loss is difficult – as difficult, perhaps, as proof of loss would have been if the sugar crop had been delivered late because shipping was missing. Whatever the loss, the parties had promised each other that $17,000 per day was a reasonable measure. The court must decline to substitute the requirements of judicial proof for the parties' own conclusion. The Moku Pahu, available on June 30, 1981, was a great prize, capable of multiple employments and enlarging the uses of the entire C and H fleet. When sophisticated parties with bargaining parity have agreed what lack of this prize would mean, and it is now difficult to measure what the lack did mean, the court will uphold the parties' bargain. C and H is entitled to keep the liquidated damages of $3,298,000 it has already received and to receive additional liquidated damages of $1,105,000 with interest thereon, less setoffs determined by the district court….

28.2.4. Deposits. Section 2-718(2) governs situations where a buyer has made a deposit on goods, and then breaches before delivery, and there is no liquidated damages clause in the agreement. In that situation, the seller may retain 20% of the purchase price or $500, whichever is smaller, and must return the balance of the deposit to the purchaser. However, § 2-718(3) provides that if the seller's damages under other Code sections are greater than those provided by § 2-718(2), the seller is free to recover damages under those sections.

☑ **Purple Problem 28-3.** A corporation entered into an agreement to purchase a used plane for $75,000, making a $10,000 down payment at the time of signing. The agreement contained a clause providing that "the deposit shall be retained by the seller as liquidated damages in the event of a breach by buyer." The buyer repudiated the contract before taking delivery of the plane. Will a court allow the seller to retain the $10,000 down payment as liquidated damages?

☑ **Purple Problem 28-4**: Nancy orders a new dryer from White's Appliance Store for a total purchase price of $600. She pays a deposit of $200. There is no liquidated damages clause in the purchase agreement. She later repudiates the contract.

1. How much of the deposit, if any, may White's retain as liquidated damages under § 2-718(2)?

2. If it has incurred damages in the amount of $200, may White's retain the entire deposit?

28.2.5. Section 2-302 also provides that a court may refuse to enforce an unconscionable contract. Is it possible that a clause that otherwise meets the requirements of § 2-718 may nonetheless be found to be unconscionable under § 2-302?

28.2.5.1. Comment 1 to § 2-302 states that the test for unconscionability is "whether, in the light of the general commercial background and the commercial needs of the particular trade or case, the clauses involved are so one-sided as to be unconscionable under the circumstances existing at the time of the making of the contract.... The principle is one of the prevention of oppression and unfair surprise ... and not of disturbance of allocation of risks because of superior bargaining power."

28.3. Limitation of Remedies under § 2-719. Section 2-719(1)(a) specifically allows the parties to (i) expand or limit ***remedies*** or (ii) limit or alter the measure of ***damages***. However, § 2-719 also imposes restrictions on this contractual freedom.

28.3.1. Comment 1 states that "at least ***minimum adequate remedies***" must be available under the contract. If a limitation of remedies or damages is such as to ***effectively deprive*** a party of any remedy, such limitation will not be enforceable. There must be "at least a fair quantum of remedy for breach" available. For example, a clause in a purchase agreement for a computer limiting damages to $1.00 would effectively deprive the buyer of any adequate remedy.

28.3.2. As with all contract clauses, § 2-302 also requires that any limitation or modification of remedies or damages not be ***unconscionable***. See Comment 1 to § 2-719.

28.3.3. Another limitation is found at § 2-719(1)(b), which provides that any remedies mentioned are ***optional unless*** the remedy is ***expressly agreed to be exclusive***, in which case it is the sole remedy available. In other words, you

need to clearly make a limited remedy the exclusive remedy, or it will only be one of many available.

☑ **Purple Problem 28-5**. Kodak provides, in its standard sales terms, that "If your camera is defective in materials or workmanship, we will repair your camera at no extra charge within one year after purchase. No other warranties apply." A buyer who purchased a Kodak camera which was defective sought to recover his purchase price. Applying § 2-719(1)(b), is the purchaser limited to a repair of the camera? Why or why not?

28.3.4. Another limitation on a party's ability to limit remedies is set forth at § 2-719(2). If an exclusive or limited remedy is provided, and the remedy ***fails of its essential purpose***, then the buyer may resort to any remedy as provided under the UCC. In other words, the parties are not free to provide an exclusive remedy that does not work!

☑ **Purple Problem 28-6**. Let's go back to the Kodak camera in Problem 5. Assume that the contract provided that "Buyer's sole and exclusive remedy in the event of a breach is the repair of the camera by manufacturer." If a buyer returns a defective camera and the manufacturer is not able to repair the camera, may the buyer seek a return of his purchase price? Why or why not?

28.3.5. Another limitation on the ability of the parties to limit remedies or damages by agreement is found at § 2-719(3). This provision allows ***consequential damages*** to be limited or excluded ***unless*** the limitation or exclusion is ***unconscionable***. It goes on to say that "limitation of consequential damages for ***injury to the person*** in the case of ***consumer goods*** is ***prima facie unconscionable***," whereas the limitation of consequential damages in a commercial setting is not.

28.3.5.1. Notice that § 2-719(3) allows the limitation or exclusion of ***consequential*** damages if such limitation is not unconscionable. Can you limit ***direct*** damages? ***Incidental*** damages? Yes, if such limitation is consistent with § 2-719(1). Of course, under § 2-302, any limitation of direct or incidental damages is also subject to the test of unconscionability.

28.3.5.2. The limitation or exclusion of consequential damages when ***personal injuries*** arise in connection with the sale of ***consumer goods*** is ***prima facie***

unconscionable. Section 1-201(b)(11) defines *consumer* to mean "an ***individual*** who enters into a transaction ***primarily*** for ***personal, family or household purposes***."

☑ **Purple Problem 28-7**. An 18-year old high school student wants to earn some extra money, so she buys a lawn mower for $300 and does lawn work for her neighbors after school. The lawn mower comes with a one-year warranty, but limits any damages (including consequential damages) for breach of the warranty to the retail list price of the lawn mower. As a result of a defective blade, the blade shatters while the student is using it and she suffers serious personal injuries, as well as other losses, such as the lost opportunity to earn money.

Is the limitation of damages, including consequential damages, ***prima facie*** unconscionable? Why or why not?

☑ **Purple Problem 28-8.** George owns and stores a valuable gun collection in his house, and he purchases an alarm system to install in his home for the protection of this collection. The alarm system was sold with the sole and exclusive remedy of "repair or replacement of parts or the system." When a burglar arrived, the siren did not go off, nor did the system alert the monitoring agency as promised, all because of a defective battery. The manufacturer of the alarm system replaced the defective battery.

1. Is the "repair or replacement of parts or the system" a minimum adequate remedy?

2. Did the remedy fail of its essential purpose?

3. Is George entitled to recover the value of his stolen gun collection?

28.3.6. Often, a purchase agreement will contain a single clause which contains (i) a limited warranty, (ii) a limitation of remedy (such as repair or replacement), and (iii) a limitation of damages. The following language, which is typical of that found in purchase agreements, is based on the contractual provisions at issue in the case of *Cooley v. Big Horn Harvestore Systems, Inc.*, 813 P.2d 736 (Colo. 1991):

> If within one year from the date of sale, any product sold under this purchase order, or any part thereof, shall prove to be defective in material or workmanship upon examination by the Manufacturer, the Manufacturer will supply an identical or substantially similar replacement part f.o.b. the Manufacturer's factory, or the Manufacturer, at its option, will repair or allow credit for such part. NO OTHER WARRANTY, EITHER EXPRESS OR IMPLIED AND INCLUDING A WARRANTY OF MERCHANTABILITY AND FITNESS FOR A PARTICULAR PURPOSE HAS BEEN OR WILL BE MADE BY OR ON BEHALF OF THE MANUFACTURER OR THE SELLER OR BY OPERATION OF LAW WITH RESPECT TO THE EQUIPMENT AND ACCESSORIES OR THEIR INSTALLATION, USE, OPERATION, REPLACEMENT OR REPAIR. NEITHER THE MANUFACTURER NOR THE SELLER SHALL BE LIABLE BY VIRTUE OF THIS WARRANTY, OR OTHERWISE, FOR ANY SPECIAL OR CONSEQUENTIAL LOSS OR DAMAGE RESULTING FROM THE USE OR LOSS OF THE USE OF EQUIPMENT AND ACCESSORIES. THE BUYER RECOGNIZES THAT THE EXPRESS WARRANTY SET FORTH ABOVE IS THE EXCLUSIVE REMEDY TO WHICH HE IS ENTITLED AND HE WAIVES ALL OTHER REMEDIES, STATUTORY OR OTHERWISE.

The question which has been presented to several courts is the following: If the manufacturer is unable to repair or replace the defective goods, and thus the limited remedy has failed of its essential purpose, does the separate limitation on consequential damages fail with it? Or should the limitation on damages be enforced unless it fails on its own merits; *i.e.*, if it is found to be unconscionable?

28.3.6.1. The majority of jurisdictions have concluded that a limitation of remedy clause is distinct from a limitation of damages clause, even if they are commingled in a single contract provision (as above). The limitation of remedy clause must be analyzed under § 2-719(2), and if it "fails of its essential purpose," the buyer may then pursue any other available remedy. However, when the buyer pursues other available remedies, the second clause limiting consequential damages will be enforced, unless it fails the unconscionability test of § 2-719(3).

See, for example, *Rheem Manufacturing Co. v. Phelps Heating & Air Conditioning*, 746 N.E. 2d 941 (Ind. 2001).

28.3.6.2. A minority of jurisdictions have ruled that if a limited remedy fails of its essential purpose, all other limitations stated in connection with it (such as a limitation of damages) also fail. For example, in *Cooley v. Big Horn Harvestore Systems, Inc.*, 813 P.2d 736 (Colo. 1991), from which the above language is adapted, the manufacturer could not repair the equipment as promised, and thus the remedy failed of its essential purpose. The court found that the limitation on damages was written in the context of the limitation of remedy, that they were dependent upon each other, and because the limitation of remedy failed, the limitation on consequential damages also failed.

28.3.6.3. A subminority of jurisdictions that strike the limited remedy also strike the limitation on damages if it is in the same paragraph, but not if it is in a separate paragraph.