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Contracts: Penalty Clauses--Legality

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NOTES

CONTRACTS: PENALTY CLAUSES—LEGALITY.—The purpose of section 1670 of the Civil Code of California[1] is to deter the use of penalties to enforce a contract. It states the equitable position (later adopted in effect by the common law) that one cannot force his fellow bargainer into specific performance by the terror of a large and unassociated penalty. It prevents a party in a superior bargaining position from denying another his right to trial and a reasonable assessment of damages. In this respect it illustrates the basic measure of damages on a contract—compensation, not punishment.

When there is an actual breach of contract and a penalty is therein assessed, such a provision will be held void unless it is a proper case under the code for liquidated damages. The question which now arises is whether it is possible to word a contract so as to overcome the fact that a clause provides for a penalty by making it part of the execution thereof. Can a party overcome the substance of the law by form?

The recent case of *Columbia Outfitting Co.* v. *Freeman*[2] supplies an illustration of when such a problem might arise. Columbia operated a retail store in San Francisco. One Freeman, by virtue of his prior success, was chosen to be the exclusive collector of Columbia's delinquent credit accounts. He was approached by Columbia's credit manager, but stated that since he would have to devote his time exclusively to Columbia he wanted the *protection* of a written agreement and submitted one to the credit manager, who accepted it. The contract gave Freeman all the interest and costs plus one half the principal on all the accounts he collected. It also had a clause, stating:

> "It is expressly understood that we (Columbia) have the right at any time to recall, in writing, any or all of the said accounts which we may have heretofore assigned to you, or which we may hereafter assign to you, and in that event you are to receive from us all costs which you may have advanced in working said recalled account or accounts, and also your full commission on the principal sum due on said recalled account or accounts."

Several thousand delinquent accounts were turned over to him, and he proceeded to work on them.

Columbia later recalled the accounts because of Freeman's aggressiveness,[3] and in an action by Columbia to recover money he had collected and was holding for them, Freeman counterclaimed for the amount due him by the recall. The court held Columbia liable to Freeman for the full commission on the principal sum stated in the contract. In so holding the court added further weight to the line of California cases which hold that a penalty can only arise on a breach.

Early in the course of California's judicial history the doctrine was laid down that the courts are not warranted in supplanting the intention of the parties, nor in

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[1]Section 1670. *Liquidating, or Fixing Amount, of Damages, for Breach.* Every contract by which the amount of damage to be paid or other compensation to be made, for a breach of an obligation, is determined in anticipation thereof, is to that extent void, except as expressly provided in the next section.

Section 1671. *When Actual Damage Difficult to Fix.* The parties to a contract may agree therein upon an amount which shall be presumed to be the amount of damage sustained by a breach thereof, when, from the nature of the case, it would be impracticable or extremely difficult to fix.

[2]94 A. C. A. 795, 211 P. 2d 640. Not to be officially reported in California Appellate Reports. A hearing was granted in the Supreme Court of California in which the present decision was reversed on other grounds. (36 A. C. 156, 223 P. 2d 21 (1950).)

[3]Freeman had secured adverse publicity for Columbia by getting a mandamus against a municipal court judge who held that a waiver of the statute of limitations on Columbia's credit contracts was void. However, Freeman's legal position was correct in this matter.

attempting to modify or reform a contract with the vague notion of relieving a party from the hardships of an agreement willingly and knowingly made.[4] Minimum payment clauses in contracts of sale or for services have been repeatedly held valid, the courts stating that the payment is a direct obligation on the contract—not a provision for liquidated damages or a penalty.[5] California courts have sustained heavy forfeitures relying solely on the fact that there was an alternative to terminate in accordance with the terms of the contract or lease, therefore making the act an execution—not a breach of the agreement.[6] The judiciary has insisted on an actual breach, in order to bring a clause within Civil Code section 1670,[7] regardless of the unassociated amount forfeited.

This view had its inception in 1768 when Lord Mansfield laid down the rule in the celebrated case of *Lowe* v. *Peers*:[8]

> "If the covenant be 'not to plow,' and there be a penalty; a court of Equity will relieve against the penalty, or will even go further than that, but if it is worded—'to pay £5 an acre for every acre plowed up,' there is no alternative, no room for any relief against it; no compensation; it is the substance of the agreement."

The doctrine was followed by Holmes, J., in the leading case of *Smith* v. *Bergengren*,[9] and there has never been a California case to the contrary. In the principal case the court, in applying the California law, states that this is not an action for breach of contract, and that the recall provision is not a subterfuge for a penalty. This writer submits that if the policy of the law is to prevent penalties, and to prevent specific performance by a threat, the whole line of authority is without merit.

The Restatement of Contracts, section 339, subsection 1, comment f, states:

> "Attempts are sometimes made to conceal the fact that the amount specified in a contract is a penalty by using words indicating that the payment is merely one of two promised alternatives or that a large discount is being allowed for a prompt payment. There is a borderline along which it is difficult to determine the question; but payment of the specified amount will not be enforced if the court is convinced that it is a penalty the purpose of which was to stimulate performance of a promise to do something else. If the parties in good faith contemplate each of two promised alternatives as an agreed exchange for the consideration given by the promisee, the contract is not within the present section. The relative value of the two alternatives will frequently be decisive."

The principal case gives us an opportunity to apply the criterion set by the Restatement to the facts. If we assume that the contract were one of revocable assignment or agency and the recall provision were not inserted, then Columbia would have had the power to recall, even though it would have been liable for breach of contract. Freeman, by inserting the recall clause said in effect, "I admit that you have the power to recall the accounts and all that I can get from that is damages for your breach of contract. However, that does not satisfy me. I want to prevent you from recalling the accounts; therefore, I will set such a price upon your recall that it will be prohib-

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[4]Streeter v. Rush (1864), 25 Cal. 67.

[5]A. B. Field & Co., Inc. v. Haven (1918), 36 Cal. App. 669, 173 P. 108; San Joaquin L. & P. Corp. v. Costaloupes (1929), 96 Cal. App. 322, 274 P. 84; Payne v. Pathe Studios (1935), 6 Cal. App. 2d 136, 44 P. 2d 598.

[6]Kulemeier v. Lack (1942), 50 Cal. App. 2d 802, 123 P. 2d 918.

[7]Miller v. California Trust Co. (1936), 15 Cal. App. 2d 612, 59 P. 2d 1035; White v. City of San Diego (1932), 126 Cal. App. 501, 508, 14 P. 2d 1062, wherein the court states that an option in its nature is a right to perform or refuse, and any sum stipulated for a refusal would be a penalty, i.e., a sum payable for what the optionee had the right to do without paying, therefore unenforceable.

[8]4 Burrows, 2225, 2229, 98 English Reprint 160.

[9]153 Mass. 236, 26 N. E. 690, 10 L. R. A. 768 (1891): "It was not a sum to be paid in case the defendant broke his contract and did what he agreed not to do. It was a price fixed for what the contract permitted him to do if he paid."