The United States sued the Le Roy Dyal Company, to enforce a liquidated damages clause in a contract between the defendant and the Commodity Credit Corporation. Under this clause, the government was to recover $3.00 per hundredweight if the Dyal Co., which was contracting with CCC to carry out the 1947 Irish potato price support program, purchased potatoes from an "ineligible" grower. The trial judge held the provision to be "in the nature of a penalty under the circumstances of this case", and gave a judgment for plaintiff for nominal damages only. The Court of Appeals for the Third Circuit reversed on appeal, on the ground that this was not a penalty, but a reasonable provision for damages that would be difficult to anticipate or to prove after breach of the contract. This, the court derived from "principles of general contract law" rather than from state law, although it concluded that state law would lead to the same result in this particular case.¹

The principal case points up two interesting problems. One relates to whether the court was free to apply "general contract law". The other is the problem of the extent to which "penalty clauses" in government contracts will be enforceable.

I. The Applicable Law

Under Swift v. Tyson,² the federal courts had exercised an independent judgment on issues of general law, with which the federal government had no concern other than the fact that the federal courts had jurisdiction. In Erie R. R. Co. v. Tompkins,³ the majority of the Supreme Court

¹ 16 Pet. (U.S.) 1 (1842).
² United States v. Le Roy Dyal Co., Inc., 186 F.2d 460 (3rd Cir., 1950). For a similar case see: Rhode Island Discount Co. v. United States, 19 L.W. 2312 (Ct. Cl. 1931), and comment, 39 Geo. L. J. 482 (1951).
³ 304 U.S. 64 (1938).
were of the opinion that the federal courts, in exercising an independent judgment on these questions of general law, had long been invading the bailiwick of the states. Under this latter decision, the federal courts must follow state law—statutory or case law—on all questions where the only federal concern is the existence of federal jurisdiction.\(^4\)

After the *Erie* case, it was supposed that its doctrine would not necessarily be limited to cases where federal jurisdiction was based on diversity of citizenship; so that, irrespective of the basis of federal jurisdiction, the federal judges would look to state decisions on all matters not peculiarly of federal concern. Of course, under this view, the federal courts would still continue to exercise an independent judgment in construing the federal constitution, statutes, and treaties; and also they were expected to exercise such a judgment in fields like admiralty\(^5\) and interstate commerce, which are especially entrusted to the federal government, although no federal statute was controlling.\(^6\)

Later cases have served to dispel the original belief that *Erie* had forever eliminated the term “general law” from the literature of the federal courts,\(^7\) and to articulate limitations which—even if implicit in *Erie*—have served to narrow its expected scope. Among these exceptions, and as to which state law will not be determinative, are:

1. Cases involving situations where a federal statute looks expressly to the application of a federal rule, and

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*Note, 16 Tex.L.R. 512 (1938), at 514, 520.*


*Note, 16 Tex.L.R. 512 (1938), at 524, 525.*

\(^6\) Id. at 516: “... it remained for the present case to eliminate completely the term ‘general law’ from the literature of the federal courts.” And compare the language of Brandeis, J., speaking for the majority of the court in *Erie R. R. v. Tompkins*, 304 U.S. 64 (1938), at page 78: “... There is no federal general common law. Congress has no power to declare substantive rules of common law applicable in a State whether they be local in their nature or ‘general’, be they commercial law or a part of the law of torts. And no clause in the Constitution purports to confer such a power upon the federal courts.” But compare the language in the Standard Oil case, *infra*, note 12.
(2) Cases in which fundamental federal policy, either statutory or non-statutory, requires uniformity in the field including the type of action involved.\(^8\)

It seems doubtful that the principal case would come under the first category. No federal statute has been found that deals expressly with liquidated damages and the kind of questions litigated in the principal case. The chief applicability of the “CCC Charter Act”\(^9\) seems to be merely that it established the CCC and thus created an entity with which the defendant could contract. Certainly the court in the principal case did not see the pertinence of any federal statute.

On the other hand, Justice Black, dissenting in Priebe & Sons, Inc. v. United States,\(^10\) argued that the authority to contract, given to a government corporation by a statute, means that, unless Congress has especially provided to the contrary, a government corporation has power to insert in government contracts clauses which would be considered a penalty under general principles of contract law. He insisted that the contract should be interpreted in terms of the Congressional enactments, rather than in terms of “elusive general contract law”\(^11\).

In support of Black’s argument, it would be said that the major purpose of Congress was to make sure that the price support program succeeded. To effectuate that program, it had established a government corporation in whose judgment a penalty clause was necessary in this type of contract. To invalidate that clause would be to contract judicially the area in which the government corporation could carry out Congressional policy. In this light, the statutory grant of power to the CCC to enter into contracts, would be subject to expansion beyond the sovereignty given contracting parties under the normal rules of contract law.

In reply to this, it might be argued that the premise is erroneous in assuming that legitimate interests of the gov-

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\(^8\) Compare the categories in Note, 59 HARv.L.R. 966 (1946), and in Reifenberg, Common Law—Federal, 30 Oana.L.R. 164 (1951).


\(^11\) Id. at 414.
ernment would not be protected under the general rules of law, and that courts must abdicate in favor of government corporations and agencies in determining what is a penalty. Later discussion of rules as to liquidated damages will perhaps shed light on the validity of the premise. More important, to read so much into a general power given the government corporation to contract, seems to be torturing the statute, just as it would be to hold that a state corporation law, in giving a corporation the power to contract, had intended that the corporation could exact penalties. Also, the old maxim could be invoked that penal provisions in a statute must be clear, though the applicability of this maxim would be clouded by the fact that the contract gave the defendant full notice of the penalty to which he became liable, and thus presumably fulfilled the policy of the maxim.

Another objection to the Black approach is that, while principles of general contract law may be elusive, so is legislative intent. What could be less predictable than the results of judicial inquiry into the minutiae of legislative documents, none of which probably were really directed to the problem faced by the court? And if legislative intent is in question, why is it not feasible to argue that the legislature intended to adopt principles of “general contract law”? Despite *Erie*, the concept of general law still exists; and it is certainly possible to infer that Congress

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12 See United States v. Standard Oil Co. of California, 332 U.S. 301, 307-308 (1947): “... the *Erie* decision, which related only to the law to be applied in exercise of... [diversity] jurisdiction, had no effect, and was intended to have none, to bring within the governance of state law matters exclusively federal, because made so by constitutional or valid congressional command, or others so vitally affecting interests, powers and relations of the Federal Government as to require uniform national disposition rather than diversified state rulings. Hence, although federal judicial power to deal with common law problems was cut down in the realm of liability or its absence governable by state law, that power remained unimpaired for dealing independently, wherever necessary or appropriate, with essentially federal matters, even though Congress has not acted affirmatively about the specific question.

“In this sense therefore there remains what may be termed, for want of a better label, an area of ‘federal common law’, or perhaps more accurately ‘law of independent federal judicial decision’, outside the constitutional realm, untouched by the *Erie* decision.”
would wish that law to settle issues which were not adverted
to in passing the bill. In other words, the writer fears that
Justice Black's view leads to an unfortunate over-reliance
upon legislative material, and a failure to take advantage
of a system of law which, according to its proponents, repre-
sents judicial empiricism at its best.

Can it be argued that Congress intended to adopt, not
general contract law, but the law of the particular state in
which the action is brought? This leads to the second cate-
gory, and the question whether uniformity is required in
the field in which this particular action lies.

The most applicable case on the points seems to be Priebe
& Sons, Inc. v. United States, in which the court construed
and invalidated a liquidated damages clause on the basis
of "general contract law". Similarly, United States v.
Standard Rice Co., United States v. County of Allegheny,
and S.R.A. v. Minnesota have not applied state law in
dealing with government contracts. Some writers have
sought to subsume these cases under a general axiom
that state law should never be applied in dealing with
governmental contracts unless some federal statute ex-
pressly refers to state law.

One of the arguments for this conclusion is that cases
instituted by the United States should not be decided under
state law, because the United States is very infrequently
a litigant in a state court. It is quite possible, the argument
runs, that, in view of its peculiar nature, the United States
would be treated in a different way from private parties.
Accordingly, there is not a sufficient body of state juris-
prudence to define for most purposes the legal status of the
federal government as a litigant, and to assert what result

13 Supra, note 10.
16 327 U.S. 558 (1949).
17 See Reifenberg, op. cit., note 8, at 168.
18 See 36 Stat. 1091 (1911); 48 Stat. 775 (1934); 50 Stat. 738 (1937);
54 Stat. 143 (1940); 28 U.S.C. §41(1). See also, Coffman, LEGAL STATUS
OF GOVERNMENT CORPORATIONS, 7 FED.BAR J. 389 (1946); Osborn v. Bank
of United States, 9 Wheat. (U.S.) 738, 6 L.Ed. 204 (1824); United States
Constitution, Article III, §2.
would probably ensue in a state court. Therefore, state law should not be referred to, because to do so would only immerse the federal judges in the morass of futile attempts to apply precedents which the state court might itself feel to be inapplicable to the United States as a litigant.19

This argument, however, seems extreme. After all, there is no reason to suppose that the federal government—especially when carrying on its activities through a government corporation like the CCC—would be treated differently in the state courts from individuals or private corporations involved in similar litigation. While, in general, the United States government occupies a favored position in dealing with individuals, why assume a probability that the contracts of its corporations would be treated by state law as subject to unique rules?20 Any special position that the government would occupy as a hypothetical litigant in a state court would be based on other things, like predilections of a jury.

If state law is to be applied in construing government contracts, the absence of predictability would mushroom in instances where the government contract had connections with several states. For example, what if the contract were entered into in New York, but related to a factory to be constructed in California, and the litigation were in a federal court in North Carolina? If, in litigation affecting the contract the federal court were compelled to apply the conflict of laws rules of the North Carolina courts to determine whether California or New York law governed, it might find a dearth of applicable precedent. So, wherever there is a conflict of laws element, the lack of predictability from following state law will be accentuated.

Someone might suggest that it is unfair for individuals dealing with a government corporation to be subjected to a rule of contract interpretation other than the familiar state rule. In reply, it can be pointed out that such a suggestion assumes what is probably false in most instances, namely

19 Compare the argument in Note, 59 Harv.L.R. 966, 969-970 (1946).
20 See Coffman, op.cit., note 18, at 405.
that the individual contracting knows the state rules of law, and had them in mind at the time of contracting. Moreover, even in dealing with a government corporation, rather than with the government as such, an individual expects to be subjected to special rules. After all the criticisms of government "red tape", are not most persons aware of the possibility that the government contract and the law governing it might be sui generis?

Occasionally, some strong state protective policy may exist in the area in which the government contract is made, and the federal government may have no strong countervailing policy. For instance, the state might require certain formalities for the obtaining of a lien, in order to protect creditors. Should not a government corporation like the CCC or RFC be subject to that policy? And yet, to graft such exceptions on the rule that government contracts are to be construed under "general law", would create a necessity to examine particular situations in order to determine the relative strength of, and the possibility of conflict between, state and federal policies. Probably, a prophylactic rule which eliminates the applicability of state law and the concomitant need of making these determinations, is justified to economize the time of federal judges and enhance predictability. The real remedy in such instances would seem to be by careful draftsmanship of the statutes dealing with the operations of the government instrumentality—draftsmanship that would, in some way, subject the government to the rules of state law where no federal interest was at stake, and where some strong state policy was involved.

If general contract law is to govern all government contracts, the Supreme Court will, of course, be the arbiter of that law. In view of the reluctance of the Supreme Court to grant certiorari freely, it is quite possible that conflicting determinations of this general law may exist in different circuits with little probability of reconciliation. But is the absence of uniformity between different circuits more frightening than the absence of uniformity as between forty-eight states? And would the Supreme Court be more troubled by
petitions for certiorari than if there were available the contention that the lower federal court had failed to heed the mandate of the *Erie* case and conform to the governing state authorities? Moreover, it seems that the argument for applying the doctrine of the *Erie* case is partially undercut by the absence of possibilities of forum-shopping as between federal and state courts in situations involving government contracts, those possibilities being one of the justifications for the *Erie* doctrine itself.

In summary, the writer accepts the principle of Supreme Court cases that government contracts should be ruled by general contract law, in the absence of some clear statutory command that some other law is to be applied. He rejects the notion, derived from Black's dissent in the *Priébe* case, that the courts should make a detailed investigation of legislative history in order to torture statutes into a manifestation of legislative intent on a point that Congress never clearly adverted to.

II. "Penalty" Clauses in a Government Contract

The contract in the principal case called for payment of $3.00 per hundredweight "as compensation and not as a penalty" in the event defendant did any one of six named acts. Defendant purchased potatoes from an "ineligible grower", one of the acts bringing this "liquidated damages provision" into operation; and the Court of Appeals held that the provision was not a penalty, but instead a "reasonable provision for damages which are exceedingly difficult to anticipate beforehand or to prove after breach."\(^2\)

Liquidated damages are said to be a sum fixed by the parties at the time of entry into the contract, as a reasonable estimate of the extent of the injury which a breach of contract will cause.\(^2\) In determining the reasonableness

\(^{21}\) *Supra*, note 1, at 463, 464.

of this estimate, courts, as in the principal case, stress the unpredictability of prospective damages. Yet it is agreed that there must be a possibility that some damage will result. Perhaps, as CCC contended, there would be a possibility of pecuniary loss through CCC’s having to purchase an amount of “eligible” potatoes equivalent to the amount of “ineligible” ones here involved; or perhaps defendant’s breach would tend to inspire imitation by other potato dealers, interfere with the flow of potatoes to market, and ultimately create a need for CCC to spend more in order to maintain potato prices. It was not shown clearly that either of these results would follow a breach of the sort in the principal case; and, significantly, the court did not rely upon these speculative items of pecuniary injury, but centered on prospects of intangible injury.

A penalty is a sum disproportionate to the damages that could have been anticipated from a breach of the contract, and which is agreed upon in order to enforce performance of the main purpose of the contract, by the compulsion of this very disproportion. A provision for a penalty is invalid by principles of general contract law. Among the hallmarks of a penalty is the subjection of the offending party to liability for the same amount whether the breach is total or partial, or where the same sum is specified for violation of any of several differing stipulations. Perhaps

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23 The court stated, at 463: “In dealing with some matters pertaining to government activities, the question of ascertaining how much pecuniary loss is caused by failure of one contracting with the government to keep his promise is especially difficult.” See also, RESTATEMENT, CONTRACTS, §339, (1932) on which the court relied:

“(1) An agreement, made in advance of breach, fixing the damages therefor, is not enforceable as a contract, and does not affect the damages recoverable for the breach, unless

(a) the amount so fixed is a reasonable forecast of just compensation for the harm that is caused by the breach, and

(b) the harm that is caused by the breach is one that is incapable or very difficult of accurate estimation.”

24 Supra, note 22.

25 Defendant’s brief, pp. 12, 13.

26 Supra, note 22. Testimony at the trial tended to indicate that the result following defendant’s breach would have been produced even if there had been no breach. Defendant’s brief, at 13.

27 Supra, note 22. See also, Note, 12 A.L.R.2d 130 at 133 (1950).
this principle could be applied in the instant case, since the same liability was imposed if defendant did any one of six different acts, which appear to be of varying importance. More important, it seems clear that the $3.00 per hundred-weight stipulation was designed by its in terrorem effect to compel performance.

It is said that penalty clauses are unenforceable because such a punishment is unjust and unnecessary, and because infliction of punishment is the function of society and not of the individual. It is questionable whether such reasons are valid here. The defendant entered the contract voluntarily, and its obligations were clearly stated. It had dealt with CCC before and knew the nature of the contract, which was a standard form.

Moreover, if it is true that penalty clauses are unenforceable because punishment is the function, not of the individual, but of society, it would seem that the government corporation—which represents the social interest—is beyond the rationale of non-enforcement. And, since the government has power to punish if it wishes, can it not be argued that a penalty clause is, in part, defensible as involving simply a means of exercising a clear authority?

Further, the unenforceability of a penalty clause is founded, in part, on the assumption that an adequate remedy in damages can be afforded by a court. And the same would seem to be true as to the policy of not granting specific performance in the ordinary commercial contract. However, in some cases involving commercial contracts, damages alone would not be adequate and so equitable relief is given. For instance, cooperative marketing associations have been able to obtain specific performance of contracts by members

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28 Liquidated damages were called for in the event defendant did any one of the following acts: (1) purchased ineligible potatoes; (2) purchased potatoes of an ineligible grower; (3) paid less for potatoes than the applicable support price; (4) failed to comply with directions of CCC to withhold certain potatoes from market; (5) sold ineligible potatoes belonging to another person; (6) sold potatoes belonging to an ineligible grower. Supra, note 1, at 461n.

29 Supra, note 22.

30 Supra, note 1, at 463.
where non-compliance might lead to disruption of the cooperative's entire program. Similarly, in the principal case, the failure to obtain compliance would disrupt the program of an organization—in this instance, a government-created organization. And so presumably, the government, if it had known of the breach in time, could have obtained a decree restraining violation of the contract. Should not the government corporation also be able, by contractual provision and the sanction of enforceable penalties, to guard against the breach? In other words, since apparently in this type of contract—because of the peculiar though intangible interest of the government corporation—there is no "right" to commit a breach of contract and pay damages therefor, it seems just to allow the parties to use an in terrorem stipulation to protect against breach. Especially is this so, since, unlike the situation of private parties, the use of such a power to exact penalties would be regulated, not by individual conscience or lack of conscience, but by an agency imbued with governmental responsibility.

Thus, it seems to the writer that the courts would do well to admit that, while the "liquidated damages" provisions in government contracts may, in view of their in terrorem purpose, come within the traditional definition of a penalty, they are nevertheless enforceable because of the peculiar interest of the government as a party.

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31 See: Packel, The Law of the Organization and Operation of Cooperatives (2d.Ed. 1947) at 156, and cases cited at note 46. At page 155: "More significant than the uncertainty of damages is the fact that the whole program of the cooperative may be destroyed and rendered abortive if such contracts are not carried out." Compare analogy presented in Note, 50 Yale L.J. 1056, at 1065,1066 (1941).