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# Having the cake and eating it too: efficient penalty clauses in Common and Civil contract law

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**Abstract**

In this paper we examine one of the areas where there is a marked difference between Civil and Common contract law, that of the enforcement of liquidated damages and more particularly of penalty clauses. Common law judges are quite reluctant to enforce liquidated damages, especially if they believe that they include penalty clauses which are not enforceable. On the contrary, in almost all European contract laws liquidated damages are readily enforced, as are penalty clauses when they are not manifestly excessive. Although most law and economics scholars have criticized Common law courts for the non-enforcement of penalty clauses, there is a sizable minority of scholars who have defended the Common law "non-enforcement" policy on the ground that penalty clauses are inefficient because they hinder efficient breach. However, and despite the merits of the arguments advanced by advocates of the non-enforcement of penalty clauses, we believe that Common law's rejection of penalty clauses is inefficient. We further show that the Civil law solution to the problem is not only comparatively more efficient, but that it can also appease the worries of those scholars who are afraid that efficient breaches will be deterred. The solution that Civil law systems give to the problem manages to enforce the parties' wishes and to avoid deterring efficient breaches. However, we point out that in order for the Civil law systems to take advantage of this superiority, the interpretation of their Civil Codes should be guided by economic analysis and the respect to the wishes of the contracting parties.


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*This kindness will I show.*
*Go with me to a notary, seal me there*
*Your single bond; and, in a merry sport,*
*If you repay me not on such a day,*
*In such a place, such sum or sums as are*
*Expressed in the condition, let the forfeit*
*Be nominated for an equal pound*
*Of your fair flesh to be cut off and taken*
*In what part of your body pleaseth me.*
–William Shakespeare, *The Merchant of Venice*[1]

## 1. Introduction

There are only a few areas left where there is still a substantive difference between Civil and Common contract law. We have elsewhere suggested (Hatzis, 2002) that an indication of the superiority of Civil law, especially in the field of contracts, is that over the last two centuries, Common law has incessantly copied the institutions of Civil law.[2] It is characteristic that all the major theoretical debates in Common contract law ended with the adoption of institutions that were similar to, or even identical with those of Civil law. Still, even today, Common and Civil law have several dissimilarities in the field of contract law. These should not be exaggerated, since the similarities between them are numerous and more important,[3] given the aforementioned tendency of Common law to borrow solutions from Civil law. Nevertheless, it would be interesting to explore the remaining differences in the light of economic analysis, in order to test the success of both systems. Which system of law is more economically efficient in those areas where differences still exist?

We have also explored elsewhere (Hatzis, 1999, 2000) four areas where there are marked differences between Civil and Common law. These areas are contract formation (Hatzis, 1999, pp. 134–169), third-party beneficiaries (Hatzis, 2000, pp. 201–210), frustration of performance (Hatzis, 1999, pp. 194–237) and efficient breach (Hatzis, 1999, pp. 170–193; Hatzis, 2000, pp. 211–217). Our research findings suggest that the solution provided by the Civil law systems in these four areas is more congenial to the one advocated by economists as the most efficient.[4] The particularistic (casuistic) and pragmatic approach of the Roman

[1] Shylock in William Shakespeare's, *The Merchant of Venice* (1600) (Act 2, Scene 2, 142–150; Shakespeare, 1988, p. 431).

[2] For example, "[T]he influence [of the Napoleonic *Code Civil*] in England and the United States was far from superficial but reached deep and long lasting layers of the law" (Mattei, 1994, p. 202).

[3] "It is, however, becoming more and more obvious today that the prevailing idea of the English Common law as constituting an entirely autochthonous achievement is a myth. For in reality, England was never entirely cut off from continental legal culture" (Zimmermann, 1994, p. 220). See generally, Bell (1995), Helmholz (1990, 1992), Mattei (1997, pp. 77–81), and Merryman (1981).

[4] See generally Hatzis (1993) for the applicability of positive economic theory (even of the wealth-maximization principle) in Civil law countries. See also Mattei (1997, pp. 179–199). The prevalent theory in law and economics maintains that the Common law process is the primary reason for the generation of efficient rules. See characteristically Rubin (1977, 1994, pp. 9–11) and the work of Richard Posner in general, mainly his treatise *Economic Analysis of Law* (Posner, 1998; also 1980). For a contrary view, see Backhaus (1989). For the "official" Chicago school statements of the efficiency of tort law, see Landes and Posner (1987), and of corporate law, see Easterbrook and Fischel (1991).

and Civil law (Zimmermann, 1990, pp. 32–33, 921) has proven to be more efficient[5] than that of the rigid theoretical Common law, whose reluctance to adopt all the successful solutions given by Civil law (although it has already adopted most of them)[6] is primarily due to the futile attempt of Common law scholars to create unified theories, based not on economic efficiency (the primary purpose of contract law), but on philosophical theories and moral ideals that are irrelevant to the parties' wishes and welfare.

This does not signify that Civil law's underlying logic is economic. But it does make the point that the long process from Roman law times to the modern Civil Codes and the parallel testing of its rules by numerous scholars, judges and contracting parties in diverse ethnic, social and economic settings, have shaped institutions that regulate the market efficiently.[7]

In this paper we will examine one of the areas where there is a very important difference between Civil and Common contract law, that of the enforcement of liquidated damages and especially of penalty clauses. Common law judges are quite reluctant to enforce liquidated damages, especially if they believe that they include penalty clauses which are not enforceable. On the other hand, in almost all European contract laws liquidated damages are readily enforced, as are penalty clauses when they are not extravagant (sometimes even then) and purely gambling.

Although most law and economics scholars have criticized Common law courts for the non-enforcement of penalty clauses, there is a sizable minority of scholars who defend the Common law "non-enforcement" policy on the ground that penalty clauses are inefficient because they hinder efficient breach. If this is true, then Common law is more efficient than Civil law in this particular area. However, and despite the merits of the arguments deployed by scholars who advocate the non-enforcement of penalty clauses, we believe that Common law's rejection of penalty clauses is inefficient. We further posit that the Civil law solution to the problem is not only comparatively more efficient, but can also put at rest the worries of scholars who are afraid that efficient breaches will be deterred.

In the next section (part II) of the paper, we will briefly present the Common law approach to the problem by discussing American and English law. In part III we will summarize the critique of Common law's non-enforcement policy by most economists. In parts IV and V we will review the minority view which defends Common law's refusal to enforce penalties and

[5] Of course, the terms are relevant and they are applicable only in the context of the relationship between Civil and Common law. But see Georgakopoulos (1997, esp. pp. 485–487).

[6] Karl Llewellyn, the UCC's main author (and a great enthusiast of the Common law process) believed (in a "New Deal spirit") that commercial law rules are best created by administrative agencies or specialized law reform organizations (Schwartz, 1997, pp. 12, 22–27). He also maintained that the rules of contract law should come at least in part from outside the Common law system in order for them to be efficient (Schwartz, 1997, p. 31), cf. Shavell (1987, pp. 277–290). Restatements have also started to assume the role of codes or statutes (Barnett, 1996, p. 528): "Courts are increasingly treating the Restatement as a statute. Judges typically look to the Restatement, rather than to even very practical and accessible legal scholarship, to ascertain the prevailing contract doctrine. They are unwilling to move beyond the safe-haven framework it provides."

[7] Of course, we do not imply that countries with civil law systems are wealthier or more efficiency-oriented than common law countries. The evidence signifies that rather the opposite is true. See esp. Mahoney (2000) (common law countries experienced faster economic growth than civil law countries during the period 1960–1992; the difference reflects the common law's greater orientation toward private economic activity and the civil law's greater orientation toward government intervention). However, we believe that this disparity should rather be attributed to different cultural traditions and historical circumstances. For more on European economic analysis of law, see Hatzis (2003).

we will attempt to answer some of the minority's concerns. Moreover, we will introduce an integrative approach to the problem which will take into consideration the strongest arguments of the minority.

In part VI we will present the approach to the problem by a number of continental Civil Codes and by the relatively recent draft of the *Principles of European Contract Law* (a European "Restatement" of contract law). As we will see, the solution that they offer to the problem manages to enforce the parties' wishes and avoids deterring efficient breaches.

In the last part VII, we will conclude by suggesting that the problem of the enforcement of penalty clauses presents yet another instance where Civil contract law is more efficient that Common contract law. However, we will once again emphasize that in order for the Civil law systems to take advantage of this superiority, the interpretation of their Civil Codes should be guided by economic analysis and the respect to the wishes of the contracting parties.

The issue of the enforcement of penalty clauses is overly discussed and debated in both economic and legal scholarship. Our intention in this paper is not to offer any new grounds for the enforcement of penalty clauses or to repeat old arguments using new fancier theories. We only wish to refocus on the most important economic theories developed, to refine and associate them in order to produce a unified, coherent and widely-accepted economic theory; and at the same time to demonstrate the extent to which Civil contract law is more sophisticated, but at the same time to show how this age-old sophistication may be lost under a formalistic technical interpretation.

## 2. The non-enforcement of penalty clauses in Common law

Common law was not always reluctant to enforce penalty clauses and forfeitures stipulated by the contracting parties. Until at least the late 17th century and the development of a rule by the Court of Chancery which enjoined them as unconscionable,[8] penal bonds were readily enforced by Common law courts. Penal bonds were sealed instruments designed to secure performance by embodying a promise to pay a stipulated sum of money (usually twice the value of the contract itself)[9] in case of breach, regardless of the actual damages caused by the breach. Another common practice from the law of mortgages was the forfeiture of the property by the mortgagee if the borrower failed to pay off the loan and interest on the due date, even though it could have been worth much more than the amount due (Atiyah, 1995, p. 298).

This Equity rule was adopted later by courts of law and led to the enactment of statutes in both England and the United States forbidding the enforcement of penalty clauses. The tradition of non-enforcement persists today, despite the opposing voices in academia (especially by economists, but also by many legal scholars) and some recent trends toward liberalization that have become manifest in judicial decisions.[10] However, this

[8] For more, see Calamari and Perillo (1987, pp. 639–640), Farnsworth (1999, p. 842), Goetz and Scott (1977, pp. 554–556), and citations therein.

[9] According to Zimmermann (1990, p. 97, n.10), their purpose was compensatory even then.

[10] See the majority opinion (and especially the theoretical discussion) of Judge Posner in *Lake River Corp. v. Carborundum Co.*, 769 F.2d 1284 (7th Cir. 1985), discussed extensively by Chirelstein (1998, pp. 181–183). See also Barnes and Stout (1992, pp. 261–262) and Butler (1998, pp. 694–696).

contradiction (which has been observed in several other areas of contract law) creates the kind of indeterminacy that critical legal scholars have identified in the past (Kennedy, 1982). Common law, torn between paternalistic impulses and the liberal tradition of contract law, leads to a fuzzy picture of the law to be enforced in this particular area.

In the United States today, the parties may negotiate a clause providing for compensation in the form of a specified amount of damages in case of breach or of defective performance (this clause can be a formula, a schedule or any other method for determining damages). These contract clauses are usually scrutinized by the courts which compare them with conventional damages. If the difference is substantial (if liquidated damages are "unreasonably" high or grossly disproportionate to the actual injury—according to the court) the relevant provisions of the contract are considered as penalty clauses[11] and are not enforceable. The courts then award a conventional remedy to the injured party as if the contract was silent and there were no agreed damages to be paid in the event of a breach.

If, however, the liquidated damages are enforceable and they are not voided as including a penalty, their enforcement does not preclude the promisee from asking for additional damages if the stipulated damages cannot cover his actual losses.[12] In fact, he can even ask for specific performance, plus damages for injury sustained after the breach,[13] unless the contract specifies that the payment of stipulated damages shall be the sole remedy.

American case law, greatly influenced by UCC and the Restatements, has formulated two conditions[14] which must hold for the stipulated damages to be enforceable:[15]

(a) The stipulated amount must be reasonable (i.e. not grossly disproportionate) in light of the harm anticipated by the parties[16] or the actual harm caused by the

[11] American courts consider this a question of law and not of fact. The same holds for English law. See McKendrick (1997, p. 387).

[12] But see *Fisher v. Schmeling*, 520 N.W.2d 820 (N.D. 1994) [cited by Farnsworth (1999, p. 843, n.12) (the promisee cannot establish actual damages in excess of liquidated damages even though he retains the right to resort to alternative legal remedies); see also *Baybank Middlesex v. 200 Beacon Properties*, 760 F. Supp. 957 (D.Mass. 1991) cited in n.11 for opposite results (enforceable stipulated damages do not preclude resort to conventional damages)]. See also UCC 2-179(2).

[13] See more generally Murray (1991, p. 703).

[14] As listed by Farnsworth (1999, pp. 844–847), quoting *Banta v. Stamford Motor Co.*, 92 A. 665, 667 (Conn. 1914) in which these conditions were initially formulated. Farnsworth refers to three conditions (the third being the intent of the parties to stipulate damages and not a penalty; i.e. there is no intent on the part of the promisee to compel performance under the threat of high liquidated damages). See also Calamari and Perillo (1987, pp. 640–641). However, the third condition is "fast disappearing" since "a liquidated damage clause is not rendered unlawful simply because the promisee hopes that it will have the effect of encouraging prompt performance" (see Farnsworth, 1999, p. 847, and citations to relevant recent cases). Both the UCC and the *Restatement (Second) Contracts* have dropped this condition. Nevertheless, see the useful advice to contract drafters (to avoid even using the word penalty in a contract) by Murray (1991, pp. 693–694), cf. McKendrick (1997, pp. 390–392). Atiyah (1995, pp. 299–300) advocates the introduction of a similar condition in English law.

[15] For typical cases applying the above conditions, see *Berger & Shanahan*, 142 Conn. 726 (1955), reprinted in Murray (1991, pp. 694–697); *Truck Rent-a-Car, Inc. v. Puritan Farms 2nd, Inc.*, 41 N.Y. 2d 420 (1977), reprinted in Fuller and Eisenberg (1990, pp. 274–278).

[16] Cf. *Hadley v. Baxendale*, 9 Ex. 341, 156 Eng. Rep. 145 (1854).

breach.[17] However, if there is no actual loss, the stipulated damages are usually not enforced[18] and when the actual loss is much lower, this is most often considered as an indication of unreasonable stipulated damages.[19]

(b) It is difficult or impossible to measure—and thus prove—the presumable loss (due to subjective valuation, uncertainty, difficulty of producing proof of damages, or any other measurement problems).[20]

It seems that the main reason for this distrust of stipulated damages by Common law judges lies in their aim to avoid the introduction of any form of punitive damages (in addition to compensatory damages)[21] for the breach of a contract.[22] The reason is that supposedly "the mere availability of such a remedy would seriously jeopardize the stability and predictability of commercial transactions, so vital to the smooth and efficient operation of the modern American economy."[23]

Not only do they not award punitive damages in order to punish the breaching party (as they do often in tort actions), but they are also more than reluctant to "tortify" the interference of a third party with contractual relations and to punish "bad faith" breaches (Farnsworth, 1999, pp. 787–791). Despite some exceptions and the sporadic enforcement of the theoretically problematic tort of "interference with contractual relationships" (Hatzis, 2000), the mainstream theory in common contract law still appears to be that "[t]he only universal consequence of a legally binding promise is, that the law makes the promisor pay damages if the promised event does not come to pass" (Holmes, 1881, p. 301).[24] Under this theory, the promisor has an option between performing according to his contractual duties and paying expectation damages to the promisee. Additionally, according to Farnsworth

[17] See UCC 2-718(1) and *Restatement (Second) of Contracts* (1981) §356. See, however, Farnsworth (1999, pp. 844–846) for an older, vanishing judicial trend which recognized only the damages that seem reasonable ex ante, i.e. at the time when the contract was made [e.g. *Seidlitz v. Auerbach*, 129 N.E. 461 (N.Y. 1920) and more recently *Arduini v. Board of Education*, 93 Ill.App. 3d 925 (1981); see also *Hutchison v. Tompkins*, 259 So.2d 129 (Fla. 1972)]. For a critique of the mainstream theory, see Murray (1991, pp. 702–703), cf. Eisenberg (1995, pp. 225–236) (at the time a contract is made it is almost always impossible to determine what the actual damages will be at the time of breach). For the unenforceability of "shotgun" clauses (where the penalty is an arbitrary amount), see Calamari and Perillo (1987, p. 644).

[18] See §339 of the *Restatement of Contracts* (1932) and §359, comment b of the *Restatement (Second) of Contracts*. But also see *Frick Co. v. Rubel Corp*., 62 F.2d 765 (2d Cir. 1933).

[19] Cf. Macaulay et al. (1995, p. 109) (if the damages provided for in the contract are grossly disproportionate to the actual harm sustained, the courts usually conclude that the parties' original expectations were unreasonable).

[20] But see *Callanan Road Improvement Co. v. Colonial Sand & Stone Co*., 190 Misc. 418, 72 N.Y.S.2d 194 (Sup.Ct. 1947) [cited by Calamari and Perillo (1987, p. 641, n.51)] for a case where the liquidated damages clause was enforced by the court despite the fact that the actual damages were readily calculable. Many jurisdictions no longer ask for this second requirement. They are content if the stipulated amount is reasonable and fair given the circumstances. See mainly *Wassenaar v. Panos*, 111 Wis.2d 518 (1983). But see *Hickox v. Bell*, 195 Ill. App. 3d 976 (1990). For an early but sound critique of the "uncertainty" requirement by C. McCormick in his treatise *McCormick on Damages* (1935), see the quotation in Murray (1991, p. 697).

[21] With some exceptions. For punitive damages in US contract law, see the excellent discussion in Macaulay et al. (1995, pp. 760–768).

[22] See, e.g. *Restatement (Second) of Contracts* §356, comment a: "The central objective behind the system of contract remedies is compensatory, not punitive."

[23] *General Motors Co. v. Piskor*, 281 Md. 627, 381 A.2d 16 (1977).

[24] See also Holmes (1897, p. 457). However, see Perillo (2000) (in Holmes's view the breach of a contract was as much an offense against the law, a legal wrong, as a tort).

(1999, p. 787), "it is a fundamental tenet of the law of contract remedies than an injured party should not be put in a better position than had the contract been performed."[25] Otherwise, this would constitute a case of unjust enrichment under Common law.

Under this theory, stipulated damages are accepted, when they are not punitive in nature, as a more accurate estimation of losses, superior to conventional damages and even superseding default clauses which seem to embody public policy. Consequently, when stipulated damages cover losses which cannot be covered by conventional remedies, the courts enforce them (Farnsworth, 1999, pp. 849–850) to the extent that they restitute actual losses and they are not in excess of these. Such cases are attorney's fees and other legal expenses,[26] damages that are not usually awarded by law (e.g. injury to one's professional reputation),[27] even consequential damages (after a formal or even informal notice by the promisee).[28]

English law is also quite ambivalent towards liquidated damages and penalties. English courts[29] have, like their American counterparts, "retained the jurisdiction" to control the content of similar clauses (McKendrick, 1997, p. 386). Liquidated damages are accepted to the extent that they are purely compensatory and not punitive. Even though English courts are not as unfriendly to liquidated damages as the American courts, they have formulated a similar test with the one employed in American case law to separate liquidated damages from penalty clauses.[30]

The stipulated damages should be intended as compensation by the parties ex ante[31] (i.e. at the time of contract negotiation and drafting) and not as a penalty imposed by the promisee in order to deter breach by the promisor. If the stipulated damages by the parties are accepted by the court as liquidated damages, then this pre-estimation by the contracting parties binds the court. The injured party, in the event of a breach, can ask only for the liquidated damages and for nothing more, even if his actual losses are far greater—unless the parties have agreed otherwise (Whincup, 1992, pp. 260–261).[32] Respectively, if the actual losses are smaller than the stipulated sum, the courts will again enforce the liquidated damages clause and will not award supplementary damages.

The most important difference (at least theoretically) with American law is that English law does not look for a "reasonable" estimation of damages (a reasonableness that would be judged to a great extent ex post), but rather for a "genuine" bona fide attempt of the parties

[25] See also Calamari and Perillo (1987, p. 640) (except within narrow limits, parties are not free to determine the remedial rights which are provided by the state and are defined by public law).

[26] See *Restatement (Second) of Contracts* §356, comment d, as well as Calamari and Perillo (1987, p. 646).

[27] See, however, Macaulay et al. (1995, pp. 107–109) for termination clauses in employee contracts (with an emphasis on the quite "unique" manager contracts).

[28] See Calamari and Perillo (1987, p. 643) and especially *Wassenaar v. Panos*, ibid. (the usual arguments against allowing recovery for consequential damages fail when the parties foresee the possibility of such harm and agree on an estimated amount).

[29] But see also the 1994 Unfair Terms in Consumer Contracts Regulations, s.3(1)(d).

[30] Formulated at the same time with American law, cf. *Banta v. Stamford Motor Co*. (1914), ibid. with *Dunlop Pneumatic Tyre Co. Ltd. v. New Garage & Motor Co. Ltd*. [1915] AC 79.

[31] See above for a similar (older) American trend which was essentially repelled by UCC. There is a similar movement in English law (from ex ante to ex post judgment on the reasonableness of the amount). See McKendrick (1997, p. 389).

[32] With the exceptions of exclusion clauses which are covered by the 1977 Unfair Contract Terms Act, s.13(1)(b), and related European Union legislation (esp. the Directive of Unfair Terms in Consumer Contracts 93/13).

to assess the probable losses ex ante.[33] It is understandable that "precise pre-estimation [is] almost an impossibility"[34] at the time of contract drafting. However, the stipulated sum should not be "extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have followed from the breach."[35]

If the court senses that the stipulated damages are not a genuine estimation of anticipated losses but are adulterated by a penalty, then the liquidated damages are not recoverable and ordinary damages are going to be awarded.[36] A close scrutiny of recent judicial decisions reveals that English courts usually do not enforce liquidated damages in the following cases: when the stipulated sum is far in excess of the probable damages after a breach; when there is an arbitrary amount for all possible breaches, independently of the damage ("shotgun" clauses);[37] in cases of disguised penal bonds; in almost all kinds of forfeitures which are not well entrenched in commercial practice and institutionalized by trade usage,[38] etc.

In the 1980s, in parallel with the resurgence of the freedom of contract principle, the House of Lords started to interpret the previous decisions, as well as contract clauses quite narrowly, in order to limit the non-enforcement of penalty clauses.[39] Thus, it enforced penal clauses which punished other types of problematic performance and not a breach,[40] as well as penal clauses which forfeited expectation damages[41] and it essentially limited non-enforceability to cases of grossly disproportionate penalties only in comparison with the actual losses.

It is evident that in the UK, as in the United States,[42] the courts have gradually—and quite hesitantly—started to enforce penalty clauses, in one way or another, especially between commercial parties, either pursuing economic efficiency or trying to enforce parties' wishes.[43] They may try (but not always successfully) to disguise this doctrinal shift with formalistic interpretations, but the truth is that the shift, as slowly as it is progressing, is definite and of no return.[44] A European legal scholar studying the recent cases will discover

[33] See McKendrick (1997, p. 389). See also *Bridge v. Campbell Discount Co. Ltd*. [1962] AC 600.

[34] Lord Dunedin in *Dunlop v. New Garage*, ibid.

[35] Ibid.

[36] See Atiyah (1995, pp. 434–435), Collins (1993, p. 343); McKendrick (1997, pp. 386–387); and Wheeler and Shaw (1994, pp. 824–825).

[37] See McKendrick (1997, pp. 391–392).

[38] But see *Damon Cia Naviera v. Hapag-Lloyd* [1985] 1 All ER 475 cited by Atiyah (1995, p. 439) (a deposit which is in the contract declared to be irrecoverable in the event of a breach is forfeitable even when the actual loss is much less). However, a deposit of over 10% (which is the customary deposit) of the contract price is considered a partial payment and is recoverable. The same applies to performance bonds. See McKendrick (1997, pp. 392–394) for more on forfeitures and deposits in English law.

[39] See esp. Atiyah (1990, p. 369). But see *Johnson v. Johnson* [1989] 1 All ER 621.

[40] See *ECGF v. Universal Oil Products Co*. [1983] 1 WLR 399 and the critical discussion by Atiyah (1995, pp. 435–436) and McKendrick (1997, p. 391) (such a rule grants relief to a man who breaks his contract and penalizes the man who keeps it). However, this unfortunate disparity is a result of the formalistic response to the problem and not of the enforcement of an otherwise efficient contract term, cf. Whincup (1992, pp. 261–262).

[41] See Atiyah (1995, p. 438) and citations therein.

[42] For the 1977 amendment of the California Civil Code, see Farnsworth (1999, p. 842, n.8).

[43] But see the remarks of Judge Posner in *Lake River*, ibid. ("Deep as the hostility to penalty clauses runs in the common law . . . "), as well as Posner (1998, pp. 144–145).

[44] See McKendrick (1997, p. 388) and especially the quote by Lord Woolf in the decision of the Privy Council in *Philips Hong Kong Ltd. v. Attorney-General of Hong Kong* (1993) 61 Build LR 41 (the principle of the non-enforceability of penalty clauses has always been subject to fairly narrow restraints). See also Harris (1992).

that Common law courts (especially in England) have already moved substantially towards the Civil law approach to liquidated damages. In part VI we will notice that the differences (in terms of law in action) are not so considerable. However, we will also recognize that Civil contract law is substantially more amenable to economic analysis and responsive to parties' wishes.

Nevertheless, this struggle by the Common law courts to combine the adherence to precedent and their modern view on penal clauses[45] has led to the aforementioned indeterminacy of the law, so obvious in both American treatises and English textbooks.[46] It is characteristic that the solutions provided by the courts are reminders of the similar futile attempts by the American courts to accommodate reliance under the classical bargain theory of contracts before the development of promissory estoppel.[47]

## 3. The economic critique of the penalty doctrine

The Common law non-enforcement of penalty clauses incited the critique of economists quite early. This critique was not only rooted in the traditional economists' distrust of any kind of paternalistic judicial intervention in economic relations in general,[48] but also in the very important economic role played by penalty clauses in commercial transactions.[49] We are going to summarize here the basic arguments for the enforcement of penalty clauses as these were developed in the economics literature of the last 30 years.[50]

[45] According to the leading American contract law scholar, Allan Farnsworth (1999, pp. 842–843): "Today the trend favors freedom of contract through the enforcement of stipulated damage provisions as long as they do not clearly disregard the principle of compensation."

[46] See, e.g. Whincup (1992, p. 260) (it is still very difficult to say which clauses will be upheld and which rejected, and what exactly are the consequences of such a decision) and Collins (1993, pp. 346–347). Reinhard Zimmermann, a leading civil law scholar, characterizes the penalty doctrine as "cumbersome and unsatisfactory" (1990, p. 107). See also Clarkson et al. (1978, pp. 352–357).

[47] See, e.g. *Hamer v. Sidway*, 124 N.Y. 538 (1891).

[48] "Two assumptions go into this policy [of the non-enforcement of penalty clauses]: that the court can estimate the real cost of my failure well enough to identify a penalty clause and that penalty clauses are never efficient. The first may be wrong; the second surely is" (Friedman, 2000, p. 151). See also the excellent discussion in Kronman and Posner (1979, pp. 253–267).

[49] Where contracting parties are "well able to avoid improvident commitments" (Judge Posner in *Lake River*, ibid.).

[50] For a recent and very useful survey of the economic literature on penalty clauses and liquidated damages, see De Geest and Wuyts (2000). De Geest and Wuyts allege that the majority of law and economics scholars defend the common law policy (ibid., 157). However, I believe that this is not the case. The most-cited papers of the economic literature on the subject are those written by economists who are very skeptical of the common law penalty doctrine, e.g. Farber (1980), Goetz and Scott (1977), Rea (1984); see also Clarkson et al. (1978) (advocating the selective enforcement of penalty clauses) and Polinsky (1983, p. 436). In addition, the majority of law and economics textbook authors are critical, see, e.g. Barnes and Stout (1992, pp. 262, 264–265), Cooter and Ulen (2000, pp. 235–237), Dnes (1996, pp. 98–99), Friedman (2000, p. 151), Harrison (1995, p. 134), Hirsch (1999, p. 135), Miceli (1997, p. 87); see also Craswell and Schwartz (1994, pp. 113–114), Goldberg (1989, pp. 161–163), Kronman and Posner (1979, pp. 260–261). It is characteristic that almost all contract treatise writers present the law and economics critique as homogeneously unenthusiastic about the penalty doctrine. See, e.g. Chirelstein (1998, pp. 181–182), Farnsworth (1999, pp. 842–843), Fuller and Eisenberg (1990, pp. 281–287), and Macaulay et al. (1995, pp. 95–104) in the United States; Collins (1993, p. 345), Wheeler and Shaw (1994, pp. 840–847), and

For economists, liquidated damages are far superior to the conventional damages awarded by the courts since they have been designed by the parties themselves. The parties have the incentives to stipulate damages that are not under- or super-compensatory, but serve the purpose of full compensation. In most cases where the liquidated damages appear to be under- or super-compensatory, this is a mirage. The parties know better than anyone else their subjective valuations of goods and performances and their stipulations serve their idiosyncratic values (Goetz & Scott, 1977, pp. 558–577).[51] But even when the damages are in fact under- or super-compensatory, this might mean respectively that the parties decided to share the risk of a future change in circumstances (under-compensatory damages)[52] or that they have included an insurance premium (super-compensatory damages).

Thus, when one contracting party is risk-averse and/or places a high subjective valuation[53] on performance of the contract and the other party is the best possible insurer against his loss, then it is only rational for the parties to include an insurance ("penalty") clause in the contract.[54] The reason why a promisee often prefers a penalty clause which is essentially an insurance clause from an outside third-party insurance contract (besides the fact that he economizes on transaction costs) is that quite often the insurance compensation cannot adequately cover damages that are non-pecuniary.[55] Additionally, a subjective value which is much higher than the market price may require a very high premium.[56]

On the other hand, with a slight increase in contract price (due to the inclusion of the penalty-insurance clause) the promisor will take extra care in his performance.[57] Since most of the times both parties wish just that (a more than average-quality credible performance in return for a more than average-price), the non-enforcement of these clauses by the courts is certainly inefficient and leads to undercompensation.[58] At the same time, the court does precisely what it tries to avoid: by prohibiting a supposed windfall to the injured party, it awards an actual windfall to the breaching party, since the penalty clause reflects an above-the-market-rate contract price because it includes an insurance premium.

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McKendrick (1997, p. 397) in Great Britain; but see also Atiyah (1995, pp. 298–299) (presenting both views—no coincidence, since Atiyah favors the penalty doctrine). See also Kornhauser (1986) (summarizing the economic analysis approach to common law's penalty doctrine as "generally adverse"). The approach adopted by De Geest and Wuyts is informed by a recent stream of technical economic papers which are rather suspicious of liquidated damages. See esp. Che and Chung (1999) and Talley (1994).

[51] For the problems that arise when courts measure subjective value, see Muris (1983) and Schwartz (1990).

[52] See esp. Friedman (2000, p. 151) (it may be perfectly reasonable to choose a penalty clause, in the expectation that it will rarely be invoked, over the alternative of giving the court a free hand to decide damages). See also De Geest and Wuyts (2000, pp. 156–157).

[53] Consumers are more likely to have idiosyncratic values than are businessmen.

[54] See Cooter and Ulen (2000, p. 236) and also Miceli (1997, p. 86).

[55] See esp. the analysis by Goetz and Scott (1977, pp. 571–581).

[56] According to Atiyah (1995, p. 299), this argument is "fanciful," since "there is no empirical evidence to suggest that penalty clauses are intended to operate like insurance contracts." However, he does not explain why the promisees are willing to pay more for a penalty clause (even in common law countries where penalty clauses are not enforceable)! He is also not persuasive in arguing that the penal clauses are "bogus promises" (since neither party believes that a penal or forfeiture clause will ever apply, then such clauses do not actually create expectations—see also Atiyah, 1990, p. 369 and esp. Atiyah (1981, pp. 57–58). But this argument is tautological.

[57] In most cases the risk is greatly diminished by the cheap "extra care" treatment by the promisor.

[58] See also Sebert (1986) (courts should give wider recognition to non-pecuniary losses by awarding punitive or supercompensatory damages, especially in bad faith breaches).

The breached contract embodies an insurance policy written by the promisor in favor of the promisee (Goetz & Scott, 1977, pp. 578–583) which is not to be compensated![59]

Moreover, the enforcement of liquidated damages solves a number of problems of contract remedies, but also of real-world contract relations:

(a) It solves the paradox of compensation (efficient breach versus efficient reliance)[60] in a better way than the conventional remedies, producing the socially optimal solution, since reliance and breach are chosen efficiently (Miceli, 1997, pp. 83–84).
(b) It facilitates the calculation of risks since it eliminates uncertainty and helps future planning by the contracting parties.[61] In fact, the damages stipulated by the parties will always allocate the contract risk optimally when the parties are risk-averse, because "the liquidated damage payment will equal the optimal damage payment" (Polinsky, 1983, p. 436).[62]
(c) It discourages opportunistic behavior by the promisor and inefficient contract renegotiation and modifications (Posner, 1998, p. 143).
(d) It reduces transaction costs (measurement problems for expectation damages and reliance damages,[63] litigation and administrative costs,[64] the cost of legal error when the miscalculation of the expectation damages leads to inefficient behavior,[65] the cost of circumventing an inefficient rule by the parties and their attorneys, direct policing costs,[66] etc.), especially in cases where the damages are not readily ascertainable.[67]
(e) It simplifies efficient breach since the breaching party, knowing exactly the amount of damages that he has to pay to the promisee in the event of a breach, can easily determine if he would be better-off after the breach. At the same time, it precludes inefficient breaches[68] caused by a hidden subjective valuation that is higher than the market

[59] According to Harrison (1995, p. 134), "to not enforce the clause upsets the balance the parties have established." See also Barnes and Stout (1992, p. 265) and Chirelstein (1998, pp. 182–183).

[60] "[I]n general, there does not exist a breach of contract remedy that is efficient with respect to both the breach decision and the reliance decision. With respect to breach, the expectation remedy is ideal, whereas with respect to reliance, the restitution remedy is ideal. Thus, which remedy is best overall depends on whether the breach decision or the reliance decision is more important in terms of efficiency" (Polinsky, 1989, p. 37). See Shavell (1980) for the first formulation of the paradox. See also Cooter (1985), Cooter and Ulen (2000, pp. 245–246), Friedman (2000, pp. 165–167).

[61] According to Collins (1993, p. 342), liquidated damages are a "device to avoid the uncertainty surrounding an award of damages." See also Barton (1972, p. 286).

[62] Including litigation costs which are not collectable by the injured party under American law.

[63] See esp. Farnsworth (1999, p. 847) and also Collins (1993, p. 342), Hillman (1997, pp. 221–224) and Macaulay et al. (1995, pp. 103–104).

[64] For the measurement of expectation damages and for the distinction between valid liquidated damages provisions and void penalty clauses by the court, see De Geest and Wuyts (2000, pp. 144–145).

[65] See esp. Schwartz (1990, pp. 383–387) and also Barnes and Stout (1992, p. 262), Ham (1990) and below under (d). See also more generally, Posner (2000).

[66] See Klein (1980).

[67] There may be a probability of escaping notice for failure to perform. For example, I promise to make widgets for you, but we both know that substandard widgets will only be spotted with a probability of 10%, so we use a high damage amount for every substandard widget to induce me to produce fewer of the substandard ones (I owe this point to Steven Shavell).

[68] Including undetected breaches (Posner, 1998, pp. 142–143).

(contract) price (consumer surplus).[69] In any case, post-breach bargaining is always available and can reduce the likelihood of an inefficient performance. The stipulated remedy provision in the contract would serve as a "bargaining entitlement" (Macaulay et al., 1995, p. 104), encouraging the breaching party to share the benefits of an efficient breach with the injured party.[70]

(f) It helps young or inexperienced professionals to convey information (Kronman & Posner, 1979, p. 224) about their reliability by offering a kind of "penal bond," i.e. a risk premium. A penalty clause is the least costly way (or the only way) for a promisor to communicate credibility to a skeptical promisee by signaling his commitment to perform.[71]

For all the above reasons, most economists criticize Common law's penalty doctrine as inefficient. The non-enforcement of penalty clauses undercompensates parties with idiosyncratic values, leads to inefficient breaches and complicates efficient breach. Furthermore, it precludes parties to signal their reliability, it substantially increases administrative and litigation costs (even negotiation costs), it encourages opportunistic behavior, it leads to inefficient renegotiation, it disregards the allocation of risk by the parties, etc. For all these reasons, the penalty doctrine discourages contracting and is one of the main reasons why some value-maximizing contracts are never concluded.

## 4. A critique of the critique

The primary concern of economists who are adherents of the penalty doctrine is that the enforcement of penalty clauses might deter efficient breaches.[72] When the liquidated damages are higher than the actual losses, then they are certainly inefficient since they compel the promisor to perform even when the cost of performing exceeds the net benefits for everyone involved. Thus, when efficient breach is possible and an award of expectation damages could cover all actual losses, a penalty (if enforceable by the courts) or a stipulated sum which is significantly larger than the amount required to compensate the injured party

[69] According to Harrison (1995, p. 126), "[t]he key to insuring that a breach will be efficient is to protect the expectancy of non-breaching party." See also Barnes and Stout (1992, p. 262), Goetz and Scott (1977, p. 574) and Hirsch (1999, p. 135).

[70] See esp. Harrison (1995, pp. 134–135).

[71] See Judge Posner in *Lake River*, ibid. (the willingness to agree to a penalty clause is a way of making the promisor and his promise credible and may therefore be essential to inducing some value-maximizing contracts to be made), Cooter and Ulen (2000, p. 237) and also Barnes and Stout (1992, p. 264) (a penalty clause resembles a payment to the promisee in exchange for his accepting the risk of dealing with the promisor), Butler (1998, p. 694), Dnes (1996, p. 98), Harrison (1995, p. 134), Miceli (1997, p. 87) and Rea (1984, pp. 156–157). But see De Geest and Wuyts (2000, pp. 152–153) (promisees are satisfied with liquidated damages which fully compensate them) and the rebuttal of their argument in Posner (1998, p. 142) (the windfall recovery of a penalty in some cases will, by offsetting losses incurred in others, enable sellers to take greater risks and charge lower prices).

[72] For the efficient breach and the importance of remedies in the decision between performance and breach, see the remarks by Judge Posner in *Patton v. Mid-Continent Systems, Inc.*, 841 F.2d 742 (7th Cir. 1988), as well as Posner (1998, pp. 133–134).

for his loss may operate in terrorem on the breaching party, deterring breach and compelling inefficient performance.[73]

There are also significant distributive consequences. According to Miceli (1997, pp. 85–86), in case of a possible efficient breach a penalty clause serves only to increase the expected surplus of the original contractors relative to the incumbent. It does not increase the overall expected surplus and it creates a barrier to entry. Thus, a limit on liquidated damages in this case enhances efficiency by preventing the parties from overcommitting (from a social perspective) to the original contract.[74]

This argument against efficient breach is valid to a certain degree and it is rarely rejected by the scholars who support the enforcement of penalty clauses.[75] However, this critique does not differentiate between the three different kinds of stipulated damages:

(a) There are arbitrary liquidated damages set high enough in order to compel performance and deter breach without the genuine assent of the promisor and without relation to the actual damages ("shotgun clauses"). The particular stipulated sum is not the result of a bargain between the two contracting parties, but it is usually inserted in the contract without the knowledge or consent of the promisor. Similar clauses are quite frequent in standard form consumer contracts.[76] Of course, the contract price does not reflect the penalty or the excessive liquidated damages. In these cases, there is no real agreement between the parties concerning the penalty clause, which is the result of a monopoly environment or of the presence of any of several formation defects. The enforcement of this penalty clause, which is an inefficient contract term, will not enhance efficiency, since (besides being abusive) similar contract terms deter efficient breaches.

These are the abusive penalty clauses that some legal scholars have in mind when they are defending Common law's penalty doctrine by arguing that the non-enforcement of penalty clauses and forfeitures is not inconsistent with freedom of contract (Atiyah, 1995, p. 439; also Atiyah, 1990, p. 369). They posit that penalty clauses are the result of unequal bargaining power[77] in consumer contracts (especially standard form contracts).

[73] See Collins (1993, p. 345) and Farnsworth (1999, p. 841). Penalty clauses are not the only agreed remedies which create powerful incentives to the would-be breaching party to stick to his promise. See, e.g. Wheeler and Shaw (1994, pp. 800–801).

[74] See also Talley (1994) (the non-enforcement of contractual liquidated damages clauses is the economically efficient means of treating such clauses to encourage renegotiation and account for transaction costs) and Che and Chung (1999) (reliance damages are more efficient than liquidated damages if ex post renegotiation is possible). See also Aghion and Bolton (1987), Chung (1992), Diamond and Maskin (1979), Spier and Whinston (1995) and Stole (1992).

[75] See however Goldberg (1989, p. 162), who defends the enforcement of penalty clauses in cases of a possible efficient breach, basing it on cultural grounds.

[76] A number of drafting techniques have also been developed for the inclusion of clauses in contracts which do not look like penalty clauses, but certainly are. Sometimes there are also hidden penalties not for breach or for imperfect performance, but for a performance which is faultless but not in accordance with the interests of the promisee (see, e.g. clauses in loan contracts penalizing early payment by parties who wish to escape compound interest).

[77] See, e.g. Slawson (1996, pp. 40–41) (the economic argument suffers from the characteristic weakness of any argument that reasons from fact to preference; consumers' lack of bargaining power is not lack of information, it is lack of understanding).

However, not all penalty clauses in consumer contracts are abusive.[78] Additionally, there is always the doctrine of unconscionability, which is "capable of coping with abusive stipulated damage provisions"[79] and which is also applied to abusive arbitration clauses. But even in these cases, when a penalty clause seems particularly harsh and abusive, it might play a specific economic role (e.g. security interests).[80]

(b) There are penalty clauses (or higher liquidated damages) which are inserted in a contract because they serve a specific economic role.[81] In these cases, the penalty clause is freely accepted by the parties, especially when the market is competitive[82] and/or the contracting parties are sophisticated enough, which is always the case in commercial contracts. The non-enforcement of the stipulated damages which are the result of bargaining between the parties is inefficient and it hurts the very people it wishes to protect by offering them an alternative they do not want to retain (possibility of efficient breach) and expropriating from them an alternative they wish to have (adding an enforceable penalty clause to their contract).[83] Efficient breach is not really an issue when a penalty clause plays an important economic role (risk sharing, reputation signaling, protection of idiosyncratic values, etc.) and the liquidated damages compensate actual losses.[84]
(c) There is also a third category of penalty clauses (which is essentially a subcategory of the second)[85] which might require special treatment: penalty clauses which are economically efficient (they are the result of bargaining, they play a particular economic role in the contract and they are reflected in the contract price) and reasonable ex ante, but seem quite excessive ex post. These clauses are usually protective of risk-averse promisees or they play an informational role, substituting the lack of reputation.

According to Clarkson et al. (1978, pp. 366–378), the enforcement of these penalty clauses may create a "moral hazard" problem, i.e. incentives for inefficient behavior by

[78] According to Collins (1993, p. 345), who is not particularly friendly to economic approaches: "the control should be confined to cases where the clause reveals some kind of coercion or oppression during the bargaining process."
[79] See Barton (1972, p. 286) and also Farnsworth (1999, p. 842), McKendrick (1997, pp. 388–389) citing *Philips*, op.cit, Collins (1993, p. 345) and Miceli (1997, p. 86) (referring to formation defenses in general). But see Fuller and Eisenberg (1990, pp. 281–282). However, even in these cases "it seems odd that courts should display parental solicitude for large corporations" (Judge Posner in *Lake River*, ibid).
[80] See, e.g. the (in)famous case *Williams v. Walker-Thomas Furniture Co*., 350 F.2d 445 (D.C. Cir. 1965) and the discussion in Cooter and Ulen (2000, pp. 280–282) (the paternalistic protection of Mrs. Williams by legal restrictions on the credit market imposes high costs on poor consumers as a class). See also De Geest and Wuyts (2000, pp. 152–153).
[81] One could even say that these are not *real* penalty clauses (Posner, 1998, p. 144), since they do not overcompensate but compensate for an unusual risk of loss.
[82] We should take into consideration that most markets are already competitive in the great majority of Western-type democracies, especially after the 1990s.
[83] See esp. the comments by Judge Posner in *Lake River*, ibid.: "the parties will, in deciding whether to include a penalty clause in their contract, weigh the gains against the costs (costs that include the possibility of discouraging an efficient breach somewhere down the road) and will include the clause only if the benefits exceed those costs as well as all other costs."
[84] See also Farber (1980) (supercompensatory damages can improve efficiency).
[85] But for De Geest and Wuyts (2000, p. 142), these are the real "penalty clauses." The supercompensatory stipulated damages which compensate subjective losses are liquidated damages.

the parties when the expected damages calculated ex ante and included into the contract as liquidated damages are much greater than the actual losses. This situation is quite frequent, especially after a price fall. In such cases, the promisee prefers breach to performance since the liquidated damages are set higher than any possible profit (or the conventional expectation damages) and thus has more to gain if the promisor breaches than if he performs. The promisee will then try to induce breach by not cooperating with the promisor or by actively sabotaging performance (as much as he can without being identified by the promisor and of course by the court). Additionally, when this sabotage cannot be proven in court but can be recognized by the promisor, this can create even more inefficient counter activities on the part of the latter, such as monitoring the promisee, trying to prevent breach inducement, gathering facts for evidence in court, etc. All these activities waste valuable resources. Therefore, when a party would gain by the enforcement of a penalty clause and has the means of making a breach happen, then the penalty should be unenforceable.

Indeed, the overcompensation is due to the fact that the determination of damages was difficult or impossible ex ante and the actual losses are far lower. However, the stipulated amount in these cases constitutes the "expected value" of damages, a value that could also be much lower than the actual losses.[86] Then the excess is not a penalty, but the result of the previous allocation of risk to the least cost avoider (who is usually the least risk-averse party).[87] The non-enforcement of the risk allocation agreed by the parties themselves is not only inefficient, but it undermines the economic role of contract as a risk-allocation mechanism.[88]

Furthermore, if there is a real danger that the promisee will induce breach, this could be reflected in the price or in the other contract terms negotiated by the parties. The existence of a penalty clause in such a case indicates that the benefit that it has for the promisee exceeds the costs to the promisor.[89] Also, the parties can always add a contract term designed to reduce the danger of opportunistic behavior (e.g. the penalty clause will not be enforceable if this kind of behavior occurs).[90]

Another concern is that the enforcement of liquidated damages would require parties to negotiate over a damage payment every time a contract is entered into, whereas the cost of applying the other remedies would be incurred only when circumstances change

[86] See esp. Miceli (1997, p. 87).

[87] See Goetz and Scott (1977, pp. 578–588) and also Rea (1984) (enforcement of damage clauses is likely to be efficient when damages are reasonable ex ante but unreasonable ex post).

[88] Especially given that law and economics scholarship supports not only the manifest allocation of risks in contracts, but also backs up any latent or hypothetical allocation of risks (e.g. it defends the assignment of liability to the party who can bear the risk of impossibility of performance at least cost). See Posner (1998, pp. 115–121).

[89] That is why there is no reason for penalty clauses to be unenforceable in case of impossibility or force majeure, as De Geest and Wuyts (2000, p. 158) argue (it is impossible for a penalty clause to have a signaling function, thus this is an instance of overinsurance). However, again, a penalty clause may be a part of a risk allocation agreed by both parties which is reflected in the contract price. I do not see any reason not to enforce such a clause in a commercial contract. However, in a consumer contract such a term would probably be abusive. See also Posner (1998, p. 143).

[90] See Kronman and Posner (1979, pp. 224–225) in their critique to Clarkson et al. (1978), as well as Goldberg (1989, pp. 163–164) and Posner (1998, p. 142).

and a breach occurs (Polinsky, 1983, p. 444).[91] This is not necessarily so. First of all, there is no reason to believe that the enforcement of liquidated damages would "require" parties to negotiate and stipulate damages "every time a contract is entered into."[92] The enforcement of penalty clauses does not lead to a regime of compulsory liquidated damages clauses.[93] Most of the times (especially in competitive markets with fungible goods) an award of expectation damages can adequately compensate the injured parties for any of their losses. Thus, it would be inefficient for the parties to spend time and money negotiating for liquidated damages when these would be almost identical to the expectation damages.[94]

If a promisee is risk-averse or has idiosyncratic values, he can ask for liquidated damages, even for a penalty clause. However, he is going to negotiate for such a clause only if the increase in contract price is covered by the increase in the value of the contract to him (which depends on the probability of breach, the consumer surplus and the degree of his risk-aversion). In any case, "the cost of moving resources to their highest value use through the market is cheaper than doing it through the court system" (Friedman, 2000, p. 151).

A related problem is the supposed increase in litigation costs caused by suits brought by parties challenging penalty clauses (Rubin, 1981), but also because of a higher probability of default due to the excessive damages (especially if we accept that penalties are included in contracts with a higher risk of breach). But this argument overlooks the fact that in an enforcement-of-penalty-clauses regime, the heavier the penalty the less likely the breach (Posner, 1998, p. 143).[95]

Finally, another problem discussed in doctrinal scholarship is that the enforcement of penalty doctrine would adulterate the principle of just compensation.[96] As we have already seen, this is an argument used in Common law courts against the enforcement of penalty clauses. In the three different categories of stipulated damages we examined previously, this argument applies only to the first and the third categories. For the first category, the doctrine of unconscionability and the formation defenses can adequately protect promisors. In the third category, some tension might exist between distributive justice (which requires just compensation)[97] and efficiency (which requires enforcement of contract terms and especially the contractual risk allocation). However, this is a broader issue that we will not

[91] For the pattern of incentives that can be created in a legal system with "free efficient breach" and enforcement of penal clauses, inferences can be drawn from Ayres and Gertner (1989, 1992); but see contra Schwartz (1996, p. 37). See also Hatzis (2000, pp. 215–217) (this combination leads to the most efficient outcome).

[92] See Cooter (1985) (most contracts leave the computation of damages until after the breach has occurred). For an older empirical study, see Beale and Dugdale (1975, pp. 53–55). But see De Geest and Wuyts (2000, pp. 146, 149–150) (rational parties do not go to court) and Rubin (1981).

[93] Which *is* inefficient. See Posner (1998, p. 145).

[94] According to Miceli (1997, pp. 83–84), the parties are more likely to set liquidated damages equal to expectation damages. See Ulen (1984, p. 356), but also Stole (1992) (when each party to a contract possesses private information whose disclosure would adversely affect its position in the contractual bargaining, rationally calculated liquidated damages will be set at undercompensatory levels).

[95] Posner (ibid.) characterizes this argument as "highly speculative" and "paradoxical."

[96] See, e.g. *Jacquith v. Hudson*, 5 Mich. 123 (1858). See also UCC 2-718 comment 1.

[97] See also a related economic argument by Farber (1983, p. 335) (the enforcement of penalty clauses will increase the number of bankruptcies leading to recession).

be discussing in this paper, especially given our belief that the primary objective of contract law is efficiency.[98]

All these caveats by law and economics scholars seem to overlook the fact that although one of contract law's main purposes is coping with market failures which lead to imperfect contracts, hence promoting efficiency, its primary goal is simply to enforce the parties' wishes.

> What about cases in which the parties' intentions, as gleaned from the language of the contract or perhaps even from testimony, are at variance with the court's notion of what would be the efficient term to interpolate into the contract? If the law is to take its cues from economics, should efficiency or intentions govern? Oddly, the latter. The people who make a transaction—thus putting their money where their mouths are—ordinarily are more trustworthy judges of their self-interest than a judge [. . . ] who has neither a personal stake in nor first-hand acquaintance with the venture on which the parties embarked when they signed the contract. So even if the goal of contract law is to promote efficiency rather than to enforce promises as such [. . . ] enforcing the parties' agreement insofar as it can be ascertained may be a more efficient method of attaining this goal than rejecting the agreement when it appears to be inefficient. (Posner, 1998, p. 105)

## 5. Efficient and inefficient penalty clauses

The problem of penalty clauses is one of the very few in contract law and economics where there is considerable disagreement among economists, but also among legal scholars. Most economists and most legal scholars might be in favor of the enforcement of penalty clauses, but we should acknowledge that the (sizable) minority has developed several strong and valid arguments against the enforcement of penalties. In the previous part, we attempted to counter some of these arguments, but without totally denying their substance.

The reason for the existence of these conflicting arguments which often cancel each other out is that there are apparently two categories[99] of penalty rules: efficient and inefficient.[100] Efficient rules are the ones which serve an economic purpose: they provide cheap insurance, they substitute the lack of reputation, they minimize transaction costs, they facilitate risk sharing, they even simplify efficient breach and enjoin inefficient breaches; above all, they compensate the idiosyncratic valuations of contracting parties.

Inefficient penalty clauses are purely gambling, unconscionable penalties. But these are almost by default scarce in commercial contracts between sophisticated parties (especially among corporations) and in most consumer (even standard form) contracts concluded in competitive markets.

The Common law courts policy of non-enforcement of penalty clauses of all kinds (an irrebuttable assumption) by not differentiating between the two, is not only inefficient, but

[98] See, however, our discussion in Hatzis (1999, pp. 106–110).

[99] As we emphasized before, the third category is a subcategory of the second category (efficient penalty clauses).

[100] See similar thoughts in Ham (1990) and Kronman and Posner (1979, p. 261). See also Hillman (2000).

also doctrinally problematic. Here we have the paradox that parties in Common law (even sophisticated promisors) are unable to stipulate the kind of damages they agree on, although they have the right to replace almost all the default rules and design a contract that is suited to their needs.[101] What makes this even more non-sensical is that Common law courts generally do not inquire into the adequacy of the consideration.

This policy has costs for the contracting parties. For example, Dnes (1996, p. 99) has found that the non-enforcement of penalty clauses which function as performance bonds undermines efficient new firms which are not able to compete with inefficient established firms by offering higher bonds.[102] Additionally, besides doing harm to the sophisticated contractual parties, the non-enforcement of efficient penalty clauses does not adequately protect weaker parties since the rule can be easily evaded.[103]

Thus, there seems to be no reason for common law courts to attach so strongly to enforcement authority.[104] The most efficient policy is one that would differentiate between the inefficient (abusive) and the efficient penalty clauses. Courts should enforce penalty clauses

[101] This paradox is traced back as early as 1925 by Alvin Brightman (cited by Chung, 1992, p. 281, n.3). See also Farnsworth (1999, p. 841): "Compared with the extensive power that contracting parties have to bargain over their substantive contract rights and duties, their power to bargain over their remedial rights is surprisingly limited." Calamari and Perillo (1987, p. 640) characterize the refusal by common law courts to enforce penalty clauses as "somewhat anomalous." For similar comments, see Atiyah (1995, p. 435) and McKendrick (1997, p. 389) ("the penalty clause jurisdiction is the anomaly, not the rule"). For a more general approach, see Kessler et al. (1986, pp. 1202–1203), as well as pp. 1208–1209 citing Corbin. See also Calamari and Perillo (1987, p. 646) and Farnsworth (1999, p. 848) for the even more paradoxical situations created by alternative performances (option contracts—sometimes reminding penal bonds) and premiums (which are essentially loopholes devised by contracting parties in order to escape from an inefficient regime and to circumvent paternalistic rules). But see Posner (1998, pp. 143–144). See also Kessler et al. (1986, pp. 1242–1243).

[102] According to Dnes (1996, p. 99):

> In the UK, the legal presumption against punitive bonds has probably deterred some firms from competing for contracts for government services. It has become common practice for consultants engaged in advising clients on contracting out services to emphasize investigation of the contractor rather than the use of performance bonds. In view of this, there may be no way for a relatively new firm to overcome the superior reputation of established suppliers [. . . ] Tendering to supply these services might be more competitive if more severe bonding practices became more legally acceptable.

[103] According to McKendrick (1997, p. 395): "What is the point of these rules if they can be evaded by the clever draftsmanship of the more powerful party?" The weaker parties are generally less likely to know that forfeitures and penalty clauses are not enforced. Even if they know it, they cannot discern or understand hidden penalties or other abusive terms. See also Farber (1980, p. 1478) (given the difficulty of detecting and litigating breaches, compensatory damages may be an insufficient deterrent to economically undesirable breaches, and supercompensatory damages may be justified).

[104] "I assume that the basic reason for this doctrine is that the infliction of punishment through courts is a function of society and should not inure to the benefit of individuals." [*Priebe & Sons, Inc. v. United States*, 332 US 407, 417; 68 S.Ct. 123, 129 (1947) (Frankfurter, J., dissenting)]. Atiyah (1995, p. 299) agrees (this form of deterrence is generally regarded as the responsibility of the state). For a more "literary" explanation, see Macaulay et al. (1995, pp. 104–107) (Shakespeare's *The Merchant of Venice*, the source of a vivid and influential image that to this day colors Anglo-Saxon culture's responses to forfeitures and penalty clauses), as well as Goldberg (1989, p. 161) (the non-acceptability of penalty clauses is culturally dependent). See also Kronman and Posner (1979, pp. 260–261) (the argument that the enforcement of penalty clauses undermines the distinction between punishment and compensation is not valid since the parties are not disputing the state's monopoly on the means of violence).

in general and they should annul only those clauses that are abusive[105] without appearing to play a specific economic role.[106] This is impossible under the rigid penalty doctrine of Common law. But it is exactly what most Civil Codes permit (if not invite) judges to do.

## 6. The European (Civil) law on liquidated damages and penalties

Penalty clauses have been enforceable in Europe since Roman times.[107] They were employed in conjunction with all sorts of transactions[108] and Roman lawyers toiled laboriously in drafting them. Not only were they enforced by the courts, but the rationale behind their enforcement was to help the promisee recover his actual losses (especially securing non-pecuniary interests), to reduce transaction costs, and to compel (!)[109] the promisor to perform according to the terms of the contract.[110] In fact, *stipulationes poenae* were highly recommended by Justinian (Inst. III, 15, 7).

According to Paulus (D. 44, 7, 44, 6), the promisee can ask only for liquidated damages and for nothing more than that, even if his actual losses were far greater than the stipulated sum. When stipulated damages went well above actual losses, they were also enforceable. Even the most excessive penal clauses were enforceable in classical Roman law.[111] However, a rather blurred rule in the Justinian Code (C. 7, 47) limiting the amount of damages to double the value of what had been promised and the Canon law's emphasis on morality and the protection of the debtor[112] led to the more "equitable" attitudes of Ius Commune, but only until the 19th century. Then, classical Roman law's liberal approach was revived by the Pandectists and eventually prevailed, although some influential scholars (like Pothier) had earlier supported the limited enforcement of penalty clauses.[113]

Today continental contract laws still abide by Roman law and enforce penalty clauses, even excessive ones. Under Civil law systems, there is no reason to distinguish penalty

[105] See esp. Goetz and Scott (1977, pp. 588–593), Craswell and Schwartz (1994) (the enforceability of liquidated damage clauses is closely related to questions concerning the proper scope of freedom of contract and the proper uses of the unconscionability doctrine), and Zimmermann (1990, pp. 106–107), Hillman (2000) (courts should strike an agreed damages provision only when it is oppressive or the product of "unfair surprise"). See also the comments of Anthony Ogus in Harris and Tallon (1989, p. 247).

[106] But see the reservations of De Geest and Wuyts (2000, p. 148) (judges can enforce inefficient penalty clauses by mistake).

[107] This brief historical introduction draws heavily on Zimmermann's excellent treatise (1990, pp. 95–113), where one can also find a plethora of citations concerning the development of the legal treatment of penalty clauses from Roman times to contemporary continental codifications.

[108] Even in family law (with restrictions, e.g. the *stipulatio ex bonis moribus concepta*).

[109] According to Zimmermann (1990, p. 95, n.2), "[e]arly Roman law [. . . ] had focused on the 'in terrorem' function."

[110] The same objectives are recognized in contemporary continental legal theory. See, e.g. Marsh (1994, p. 329) for French law.

[111] However, Roman lawyers devised methods to protect the debtor. For details, see Zimmermann (1990, pp. 110–113), esp. for the "equitable" principle *semel commissa poenol non evanescit*.

[112] According to Canon law, whatever was beyond a reasonable pre-estimation of damages constituted an unjustified gain.

[113] There were also some legal systems which hesitantly started to reduce excessive penalties *ad bonum et aequum* (e.g. the Prussian Code, the law of the Netherlands, etc.).

clauses from liquidated damages[114] since they are both enforceable. However, when a penalty clause is excessive (i.e. disproportionately high), courts have retained the discretion to reduce it to a reasonable amount, but only if the promisor asks for it. Nevertheless, the courts generally resort to this power in exceptional cases.

The turning point in the shift from the unlimited penalties of classical Roman law to the contemporary "equitable" approach was the final draft of the German Civil Code (*BGB*), where, after much deliberation and opposition by the adherents of the old liberal Pandectist doctrine, the power of the judge to limit excessive penalty doctrines was instituted.[115] According to BGB §343, when the reasonableness of a penalty clause is judged by the courts, non-pecuniary losses and idiosyncratic values should be taken into consideration.[116]

However, this power of the court does not apply in commercial contracts between businessmen.[117] At the other extreme, according to the German Standard Contract Terms Act (AGBG §11, s.18(d) 5), a liquidated damage clause in a standard form contract is void if the damages either exceed the amount normally to be expected in cases to which the agreement applies, or prevent the other party from proving that the party stipulating the damages either did not suffer any damages or that they were substantially lower than the stipulated amount (Marsh, 1994, pp. 232–233). The same rule applies when the actual losses were in excess of the stipulated sum.

According to the Swiss law of Obligations (§161(2) OR) and the German Civil Code (§§340 (2) and 341(2) BGB),[118] the penalty constitutes the minimum level of damages (Marsh, 1994, p. 232). The promisee can always ask for conventional damages if the liquidated damages fail to provide sufficient protection (Zimmerman, 1992, p. 101), unless, of course, the contract specifies that the payment of stipulated damages should be the sole remedy.

French law is more faithful to the Roman law's liberal approach. It is characteristic that the old article 1152 of the French (Napoleonic) Civil Code provided (following classical Roman law) that if the contract stipulates "a certain sum of damages, no larger or smaller amount can be awarded." This clause was amended as late as 1975. Under the amended statute, the judge can at his discretion "reduce or increase the agreed penalty if it is either derisory or manifestly excessive"; thus, the new statute brings the French *Code Civil* in line with other European Civil Codes.[119] However, in making this decision (which is in his *pouvoir souverain*), the judge should take into account, as in the *BGB*,

[114] For French law, see Marsh (1994, p. 200). But see Marsh (1994, p. 232) and Zimmermann (1990, p. 108, n.79) for a contradictory recent trend in German courts.

[115] See similar rules in the Dutch contract law (see §§6:94 and 233 of the new Dutch Civil Code) as well as Hartkamp and Tillema (1995, p. 94), in Spanish contract law (see §1154 of the Spanish Civil Code, as well as Whincup, 1992, p. 271), in Greek contract law (see §§402–409 of the Greek Civil Code, as well as Stathopoulos, 1995, pp. 121–125) and in Italian contract law (see §§1382–1384 of the Italian Civil Code).

[116] See also §163(3) of the Swiss Law of Obligations and §1384 of the Italian Civil Code.

[117] See the German Commercial Code (HGB §348). However, there is always the principle of good faith (see BGB §§138 and 242) to restrict some extreme cases. See also Hartkamp and Tillema (1995, p. 94) for a similar rule in Dutch law.

[118] Both based on Iulianus (D. 19, 1, 28) (parties can recover actual damages if they exceed the sum fixed as penalty). In Italian law, in the absence of an express provision to that effect, the promisee cannot recover more than the penalty (Criscuoli & Pugsley, 1991, p. 132).

[119] This rule applies only to consumer contracts and it can be claimed only by a consumer against a businessman.

the purpose of the penalty clauses as stated by the parties and he should state the reason for the reduction. Nevertheless, the parties cannot stipulate that an excessive penalty clause cannot be reduced by the court.[120] As in English law, the parties are obliged to respect their stipulated sum, independently of the actual losses (even though the promisee can ask for specific performance or rescission—but losing the amount of penalty). The promisee does not have to prove actual losses and the penalty does not have to be reasonable ex ante.[121]

The members of the Commission on European Contract law managed to combine the best elements of the two different European legal families in article 4.508 (*Agreed Payment for Non-Performance*) of the *Principles of European Contract law* (a "restatement" of European contract law and the precursor to a European Civil Code):[122]

(1) *Where the contract provides that a party who fails to perform is to pay a specified sum to the aggrieved party for such non-performance, the aggrieved party shall be awarded that sum irrespective of his actual loss.*
(2) *However, despite any agreement to the contrary the specified sum may be reduced to a reasonable amount where it is grossly excessive in relation to the loss resulting from the non-performance and the other circumstances.*

Of course, if the parties stipulate in their contract that the specified sum is the minimum sum payable by the non-performing party, the aggrieved party may choose to recover a greater amount by recourse to conventional damages.[123] Judges obtain the power to intervene only when there is a "gross disparity" between the stipulated sum and the actual losses. But the court cannot reduce the award to the actual loss; it can only fix an intermediate figure.[124]

## 7. Conclusion: remarks on comparative efficiency

We believe that our analysis has clearly shown that Civil contract law is more efficient, or at least closer to the views of mainstream economic scholarship in its treatment of penalty

[120] A similar restriction of penal clauses in standard form consumer contracts is also applicable in French law and the European Union directives. For French law, see more extensively in Nicholas (1992, pp. 232–236). The same law applied in Belgium (see Belgian Civil Code §§1152 and 1229) until 1970, when the Court of Cassation intervened and essentially introduced the non-enforcement of ex ante unreasonable penalty clauses in a regime that was almost identical to English law. If the stipulated damages are a reasonable pre-estimation of the actual losses, then the court cannot modify them (Herbots, 1995, pp. 149–150).

[121] According to Tallon in Harris and Tallon (1989, p. 287), one of the principal objectives of the French legal system is to avoid the judicial quantification of damages!

[122] See Lando and Beale (1995). There is no provision on penalty clauses in the Vienna convention. This means that the parties will be able to enforce penalty clauses if the law of jurisdiction permits enforcement (Macaulay et al., 1995, p. 110). According to §7.4.13 of the UNIDROIT Principles: an aggrieved party is entitled to recover a specified sum "irrespective of its actual harm," though the sum may be "reduced to a reasonable amount where it is grossly excessive in relation to the harm resulting from the non-performance and to the other circumstances." This rule is identical to the one found in various Civil codes and in the *Principles of European Contract Law*.

[123] See comment (a).

[124] See comment (b).

clauses than Common law. As we stated earlier, the most efficient policy on stipulated damages would require a differentiation between inefficient (abusive) and efficient penalty clauses. Courts should enforce penalty clauses in general and they should annul only those clauses which are abusive and do not appear to play a specific economic role. This "efficiency test" is possible in every Civil contract law, provided that judges will accommodate economic theory in their interpretation of contracts. There is no other criterion for differentiating between "reasonable" and "abusive" penalty clauses than the one offered by economic theory as presented in this paper.

We observed that this differentiation is not unknown to European legal systems, as it is obvious in their disparate treatment of commercial and consumer contracts (especially in Germany). The parties can stipulate the damages that best protect their idiosyncratic valuations without fearing that the courts will negate them. The allocation of risk between the parties will be respected in both under and supercompensation, and the contract can also function as an insurance policy under the blessings of a court that will never upset the balance of the contract as stipulated by the parties.

However, an economic theory will make the interpretation more sophisticated,[125] for example by offering the judges a perspective that is absolutely necessary for their treatment of problems such as (but not restricted to) the opportunistic deterrence of an efficient breach, the problem of credibility of young professionals and the impact of their decision on all kinds of transaction costs.

Another renowned contract law scholar, G. H. Treitel in his *Remedies for Breach of Contract* (cited by Whincup, 1992, p. 261) laments the Common law policy:

> The common law rules for distinguishing between penalties and liquidated damages manage to get the worst of both worlds. They achieve neither the certainty of the principle of literal enforcement, since there is always some doubt as to the category into which the clause will fall, nor the flexibility of the [civil law] principle of enforcement subject to reduction, since there is no judicial power of reduction.

Chirelstein (1998, p. 180) believes it is doubtful "that the courts would ever be willing to give up the damage-setting function to the contracting parties themselves." However, when we read decisions such as *Wassenaar v. Panos*[126] in the United States and *Sport International Bussum v. Inter-Footwear*[127] in Great Britain, we cannot but hope that Civil law will continue to do what it has done successfully for so many centuries: follow the lead of Roman (Civil) law.

In the meantime, Civil law can get the best of both worlds, in other words, to have its cake and eat it too. With the help of economic theory, it has the potential to achieve the best enforcement possible in a no-free-lunch world.

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[125] Of course it is hard to know whether flexibility is efficient. That depends on what judges do with their flexibility, and given the ambiguity of whether penalties are efficient, it's hard to believe that judges with flexibility will enforce them more efficiently than judges with less flexibility (I owe this point to Eric Posner). Thus, a greater flexibility is only efficient when judges are economically sophisticated. I am not saying that civil law is necessarily more efficient, but that it has the potential to be if it is implemented efficiently.

[126] Ibid.

[127] [1984] 1 WLR 776.

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