A theory of efficient penalty: Eliminating the law of liquidated damages
DiMatteo, Larry A
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A THEORY OF EFFICIENT PENALTY: ELIMINATING THE LAW OF LIQUIDATED DAMAGES

Larry A. DiMatteo[*]

If a man shall steal an ox, or a sheep, and kill it; he shall restore five oxen for an ox, and four sheep for a sheep.

Exodus 22:1

I. INTRODUCTION

A critique of the law of liquidated damages is important both for reasons of praxis and theory. From a practical perspective, such liquidated damages clauses[1] are commonly found in many types of

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[*] Assistant Professor, University of Florida, J.D., Cornell Law School. This article was presented as a working paper at the Hurst Research Seminar at the University of Florida in February 2000. I am grateful to all the participants at the Seminar, especially Rita Marie Cain, Donald Mayer, Virginia Maurer, and Robert Thomas for their helpful comments. I am also thankful for the able research and excellent editorial assistance of Amy Reisinger of the Class of 2000.

[1] Liquidated damages refer to a provision in a contract in which the parties agree to prevent litigation on the issue of damages in the event of breach. It is sometimes labeled as a stipulated damage clause or agreed damages provision. The law of liquidated damages refers to the peculiar body of principles developed by the common law that provide roadblocks to the parties ability to draft clauses that will be judicially enforced. Liquidated

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contracts, from employment to construction contracts. A number of reasons exist for the popularity of these clauses. First, because of the fears and costs associated with litigation, parties who draft such clauses do so in the hopes that they will preclude the need for litigation. At the very least, a liquidated damages clause may encourage the parties to settle before the trial phase or to provide some evidentiary value at trial. Parties have also used liquidated damages clauses as a mechanism for retaining monies that have been deposited or paid under the contract.[2] Finally, a party concerned foremost with performance, especially a timely performance, may use such a clause in the hope that it will provide a further inducement for performance.

The second perspective from which to review this area of contract law is the theoretical. The law of liquidated damages is unique within the common law of contracts because it overtly affronts freedom of contract. The freedom of parties to structure their own agreement is universally acknowledged to be at the heart of the common law of contracts.[3] In contrast to this freedom of contract, the limited enforcement of liquidated damages clauses, in which parties have agreed to a specified measure of damages in the event of breach, is a

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damages clauses will be used interchangeably with penalties or *penalty clauses*. Liquidated damages clause is the more generic label with penalty being a sub-set. Also, penalty is used to designate those liquidated damages clauses that are unreasonable and unenforceable. Since it is penalty clauses that are not enforced, this Article will necessarily focus its attention on these types of clauses.

[2] This purpose of the liquidated damages clause is commonly seen in the real estate sales contract. The contract may provide that the buyer's earnest money deposit is to be retained as liquidated damages by the seller in the event that the buyer fails to close on the property. *See, e.g.*, Wallace Real Estate Inv., Inc. v. Groves, 881 P.2d 1010 (Wash. 1994).

[3] The exact scope of the right of parties to structure their agreement as they see fit under freedom of contract is open to debate. The narrowest idea of freedom of contract has been labeled as the *security of exchange*. Under this adage the party who performs first is secure that if the other party fails to perform, then the law will provide a legal remedy. A stronger form of freedom of contract may be labeled as the *sanctity of contract*. This adage holds that the law's primary goal is to require a party to honor its contractual obligations. The importance of this distinction to the efficient breach argument against the enforcement of penalty (liquidated damages) clauses has been made by Richard Epstein. "The sanctity of contract is analogous to the absolute rights of private property in a world devoid of the power of eminent domain. More specifically, sanctity of contract rejects the principle of efficient breach." This point will be more fully developed in Part IV. *See* RICHARD A. EPSTEIN, CONTRACTS SMALL AND CONTRACTS LARGE: CONTRACT LAW THROUGH THE LENS OF LAISSEZ-FAIRE 8 (Univ. of Chicago, Law & Econ. Working Papers 2d Series 1997).

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long recognized exception. The non-enforcement of liquidated or stipulated damages clauses, those that are classified as excessive penalties, is justified on public policy and fairness grounds.[4] But why are liquidated damages clauses singled-out for specialized scrutiny? This scrutiny is especially questionable in the cases where such clauses are a clear expression of the parties' intentions. The law and economics literature is rich in analysis regarding the efficiency of enforcing or not enforcing liquidated damages clauses. General economic theory suggests that any express agreement between rational contracting parties should be fully enforced. However, an efficient breach argument can be made in favor of the non-enforcement of penalties, namely, that a party may be deterred from an otherwise efficient breach because of the punitive nature of the stipulated damages.

The law of liquidated damages embodies the language of dichotomy. The law is characterized by the great divide between enforceable liquidated damages clauses and unenforceable penalties. Parties may agree to stipulated damages but only at an amount that is considered reasonable. An amount above anticipated or actual compensatory damages is presumed to be a penalty, and the common law abhors penalties.[5] The incongruity between freedom of contract principles[6] and the non-enforcement of penalty clauses has generated

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[4] Brecher v. Laikin, 430 F. Supp. 103, 106 (1977).

[5] *See, e.g.*, H. Lloyd, *Penalties and Forfeitures*, 29 HARV. L. REV. 117 (1915). Plucknett cites a 1309 case in which relief is granted against a penalty. The court reasoned that "this is not properly a debt but a penalty; and with what equity can you demand this penalty?" THEODORE F.T. PLUCKNETT, A CONCISE HISTORY OF THE COMMON LAW 677 (5th ed. 1956). More recently, a court stated that "this can be nothing more than a penalty which equity will *always* relieve against." Justine Realty Co. v. Am. Nat'l Can Co., 976 F.2d 385, 389 (8th Cir. 1992) (emphasis added).

[6] Freedom of contract supports the full enforcement of bargained-for exchanges. Such enforcement is deemed to advance the goals of efficiency and certainty of contract. The private nature of this model necessarily provides for only a limited role for judicial intervention. The philosophical support for freedom of contract was laissez-faire economics. In short, the basis for enforcement should be the intent or agreement of the parties. It was not for the courts to determine the normative values of a given transaction. Professor Atiyah states that "the law of contract was designed to provide for the enforcement of private arrangements . . . . In general the law was not concerned either with the fairness or justice of the outcome . . . ." P.S. ATIYAH, AN INTRODUCTION TO THE LAW OF CONTRACT 9 (4th ed. 1989).

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an extensive body of scholarly commentary.[7] The most recent analysis has evolved from the law and economics school.[8] It is to the law and economics literature that this Article will turn in judging the rationality of the just compensation principle as it relates to the law of liquidated damages.

A theoretical dichotomy has developed among law and economics scholars in the critiquing of the current law of liquidated damages. Arguments have been spun criticizing the non-enforcement of liquidated damages clauses as the inefficient preemption of private bargaining. Professors Goetz and Scott formed their critique in favor of the enforcement of penalty clauses.[9] They used a model of the *most efficient insurer* to argue that the performing party to the contract is the best insurer. A penalty clause is the insurance policy for which the

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[7] Geoffry V. Case, *A New Standard for Liquidated Damage Provisions Under the Uniform Commercial Code?*, 38 OHIO ST. L. J. 437 (1977); Jeffrey B. Coopersmith, *Refocusing Liquidated Damages Law for Real Estate Contracts: Returning to the Historical Roots of the Penalty Doctrine*, 39 EMORY L.J. 267 (1990); Fritz, *'Underliquidated' Damages as Limitation of Liability*, 33 TEX. L. REV. 196 (1954); Ian Macneil, *Power of Contract and Agreed Remedies*, 47 CORNELL L.Q. 485 (1962); Justin Sweet, *Liquidated Damages in California*, 60 CAL. L. REV. 84 (1972); James A. Weisfield, *"Keep the Change!": A Critique of the No Actual Injury Defense to Liquidated Damages*, 65 WASH. L. REV. 977 (1990); William S. Harwood, Note, *Liquidated Damages: A Comparison of the Common Law and the Uniform Commercial Code*, 45 FORDHAM L. REV. 1349 (1977); *see also* Alvin C. Brightman, *Liquidated Damages*, 25 COLUM. L. REV. 277 (1925); Lloyd, *supra* note 5. *See generally* E. Allan Farnsworth, *Legal Remedies for Breach of Contract*, 70 COLUM. L. REV. 1145 (1970).

[8] Kenneth W. Clarkson et al., *Liquidated Damages v. Penalties: Sense or Nonsense?*, 1978 WISC. L. REV. 351; Charles J. Goetz & Robert E. Scott, *Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach*, 77 COLUM. L. REV. 554 (1977); Andrew Ham, *The Rule Against Penalties: An Economic Perspective*, 17 MELB. U. L. REV. 649 (1990); Alan Schwartz, *The Myth that Promisees Prefer Supracompensatory Remedies: An Analysis of Contracting for Damages*, 100 YALE L.J. 369 (1990); Samuel A. Rea, Jr., *Efficiency Implications of Penalties and Liquidated Damages*, 13 J. LEGAL STUD. 147 (1984); Paul H. Rubin, *Unenforceable Contracts: Penalty Clauses and Specific Performance*, 10 J. LEGAL STUD. 237 (1981); Eric L. Talley, *Contract Renegotiation, Mechanism Design, and the Liquidated Damages Rule*, 46 STAN. L. REV. 1195 (1994); Note, *Liquidated Damages and Penalties Under the Uniform Commercial Code and the Common Law: An Economic Analysis of Contract Damages*, 72 NW. U. L. REV. 1055 (1978); *see also* Lewis A. Kornhauser, *An Introduction to the Economic Analysis of Contract Remedies*, 57 U. COLO. L. REV. 683, 720-21 (1986); Timothy J. Muris, *Opportunistic Behavior and the Law of Contracts*, 65 MINN. L. REV. 521, 580-88 (1981); Craig S. Warkol, *Resolving the Paradox Between Legal Theory and Legal Fact: The Judicial Rejection of Efficient Breach*, 20 CARDOZO L. REV. 321, 326-27, 329-30 (1998). *See generally* Richard Craswell, *Contract Remedies, Renegotiation, and the Theory of Efficient Breach*, 61 S. CAL. L. REV. 629 (1988).

[9] Goetz & Scott, *supra* note 8.

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other party is willing to pay a premium. In the alternative, when a penalty clause is not included, the non-breaching party will be forced to take inefficient precautions (such as third-party insurance) in order to insure against breach. It would be more efficient to enforce the penalty clause than to force the parties to take other precautions or use other remedies. Other scholars have argued that the current law is efficient as currently constituted. In short, they claim that penalties are inefficient because they deter efficient breach. Clarkson, Miller, and Muris have argued that the non-enforcement of penalty clauses is indeed an efficient rule of contract law. Their primary argument is that penalty clauses, if enforced, produce an incentive for the non-performing party to induce a breach by the performing party.[10] In short, the penalty clause provides opportunism for the non-breaching party. However, unlike the opportunism that supports efficient breach theory, non-breaching party opportunism is not conducive to creating additional societal wealth or utility. This Article will argue that the current dichotomies are overly simplistic. It will argue that penalties may be either efficient or inefficient. Therefore, a law that holds all penalties as per se unenforceable is necessarily flawed. A *theory of efficient penalty* recognizes that the presumption in favor of the enforcement of liquidated damages clauses should be expanded to include liquidated damages *qua* penalties. Only liquidated damages clauses that are products of inefficient bargaining should be subject to judicial intervention. The first tool for such intervention should be reformation and not the rescission-only mandate found in the current law of liquidated damages.

Generally, the law of liquidated damages masks an unwarranted judicial intervention into freedom of contract. The courts and legal scholars have failed to adequately rationalize the law's interventionism to void liquidated damages clauses.[11] Professor Hillman has

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[10] Clarkson et al., *supra* note 8. Professor Schwartz offers a different accounting. He argues that such inducement to breach is unlikely because the parties are unlikely to negotiate an intentional penal amount in the first price. This is based upon the fact that the price will be inflated due to the incorporation of the penalty clause "penal price." If the beneficiary of the penalty clause fails to induce breach, then he will be worse off since the penal price is greater than the compensatory price and thus his gain from the performance will be diminished by the price difference. Schwartz, *supra* note 8, at 375.

[11] A recent attempt to understand liquidated damages law is being undertaken by Cornell law professor Robert A. Hillman. Professor Hillman applies economic-psychological analysis to the quandary of liquidated damages law. Robert A. Hillman, Behavioral

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referred to this area as the "great paradox in contract law."[12] Ironically, courts have voided liquidated damages clauses under the banner of *intentionality*—namely that one of the parties did not intend to liquidate damages despite the existence of an express term stating otherwise. Hence, the law of liquidated damages severely limits the parties' freedom to agree to pre-set damages in most cases. Unless the clause meets necessary requirements, the parties' pre-agreed remedial response to a breach of contract is replaced by one fashioned by the courts ex post.

In order to argue for the elimination of the law of liquidated damages, one must first critique the law as currently constituted. Part

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Decision Theory and Liquidated Damages (June 4, 1999) (unpublished manuscript on file with author) (hereinafter Behavioral Decision Theory). A number of decision-making techniques outlined by Hillman are especially relevant to liquidated damages law. A number of these techniques can be utilized to rationalize liquidated damages law. First, the notion of "bounded rationality" indicates that "human beings are not particularly good at thinking rationally." *Id.* at 4 (quoting CHRISTINA LEE, ALTERNATIVES TO COGNITION 81 (1998)); *see* Robert A. Hillman, *The Limits of Behavioral Decision Theory in Legal Analysis: The Case of Liquidated Damages*, 85 CORNELL L. REV. 717 (2000). To the extent that this is true, supporters of the status quo would assert that the liquidated damages clause is an instance where parties are not acting rationally. Therefore, close scrutiny by the courts may be justified if a party has irrationally waived her rights to a legal remedy. Furthermore, the use of an *availability heuristic* namely the past experiences of satisfactory performances results in the contracting parties irrationally diminishing the probability that the liquidated damages clause will be triggered. Most people, judges and juries included, display a *fairness orientation.* Contract law's aversion to penalties can be seen as a reflection of this orientation. A number of concepts borrowed from behavioral decision theory can be used to frame arguments against liquidated damages law as currently constituted. The *hindsight bias* can be used to attack the courts' voiding of clauses where the liquidated damages amounts are disproportionate to the actual damages provable at the time of trial. In reviewing the reasonableness of liquidated damages clauses judges often "overstate the predictability of past events." Hillman, *supra*, at 8 (citing Jeffrey J. Rachlinski, *A Positive Psychological Theory of Judging in Hindsight*, 65 U. CHI. L. REV. 571, 571 (1998)). Thus, a clause that seemed to be a reasonable estimate by the parties of likely damages becomes unreasonable from the perspective of judicial hindsight. Also, contracting parties may demonstrate an *ambiguity aversion* to uncertainty in contracting. "People prefer certainty over ambiguity and make choices to avoid uncertainty." *Id.* at 10. Liquidated damages clauses can be seen as the parties' attempt to remove the uncertainty pertaining to the risks and costs of breaching the contract. Ultimately, Professor Hillman concludes that behavioral decision theory offers too varied observations to lend guidance to a reformulation of liquidated damages law. "Behavioral decision theory fails . . . to resolve the mystery of liquidated damages." *Id.* at 27.

[12] Hillman, *Behavioral Decision Theory*, *supra* note 11, at 3.

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II of this Article reviews the philosophical constructs that underlie the law of liquidated damages. The twin pillars of contract remedies, freedom of contract and just compensation, will be analyzed. Freedom of contract is viewed from the perspective of party-constructed justice. This perspective augurs in favor of the enforcement of penalty clauses, especially when they are the products of fair bargaining. In contrast, the just compensation principle sees remedial justice as based upon notions of substantive equality and equity. Thus, the non-breaching party's recovery should be limited to compensatory damages as measured through the expectancy interest. The non-breaching party should not be made better off then it would have been under full performance. An analogy is drawn from the rule against the granting of punitive damages. Part II concludes with a comparative analysis of penalty law in other legal systems. The difference in the approach to penalties in the civil law system demonstrates that the common law of liquidated damages is primarily a historical creation.[13] The non-enforcement of penalties is not the inevitable product of an advanced contract law system.

Part III reviews the chaotic jurisprudence that presently surrounds the law of liquidated damages. This jurisprudence has produced numerous standards for judging the reasonableness of liquidated damages clauses. The one, two, and three-pronged approaches to reasonableness have been used and misused to create numerous other permutations of these standards. The confused jurisprudence includes differences of opinion on the "no actual injury defense" and the burden of proof. Part III concludes with a review of the techniques used to contract around the law of liquidated damages. Most attempts to circumvent the current law have met with failure. In actuality, the courts have expanded the reach of the law by broadening the definition of liquidated damages. The designation of attorney fee clauses as liquidated damages is given as an example of this phenomenon.

Part IV will examine the economic arguments in favor of and against the current non-enforcement of penalty clauses. Efficient breach arguments for not enforcing penalty clauses will be examined

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[13] The law against penalties evolved from the English courts of equity to restrict the enforcement of penal bonds that were used to insure a contractual performance. The penal nature of such bonds were considered inappropriate to redressing the harm of a contractual breach. *See generally* WILLIAM S. HOLDSWORTH, A HISTORY OF ENGLISH LAW 293 (1924).

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first. The most common arguments are that penalty clauses induce inefficient performance and produce negative externalities. This Article rejects these arguments in favor of general economic theory arguments that support enforcement. It is argued that enforcement of penalty clauses will increase efficiency in contracting and dispute resolution. The final section of Part IV asserts that the current dichotomy between liquidated damages and penalties is too simplistic. Instead, a third category of liquidated damages clauses, *efficient penalties*, should be recognized. Enforcement of such penalty can be justified under both fairness and efficiency grounds. The recognition of efficient penalties requires that the current understanding of a penalty, as an unenforceable inducement to perform, be reformulated.

Part V reviews various provisions of the Uniform Commercial Code that can be used to better understand why the law of liquidated damages is aberrational within the Code's model of contractual exchange. These provisions include Section 2-718 (liquidated damages), 2-719 (limitation of liability), 2-302 (unconscionability), and 2-615 (impracticability). Two recent proposals to revise the law of liquidated damages will also be presented: (1) Revised Article Two of the Uniform Commercial Code and (2) the *Contract Code* written under the auspices of the English Law Commission. The English revision effort comes closer to fundamentally changing the law of liquidated damages than the American revision effort. Ultimately, however, both attempts fall short. Part V also suggests that reformation is the best vehicle for reconciling judicial intervention in the area of liquidated damages with freedom of contract.

This Article will conclude that, for reasons of efficiency and fairness, the current tripartite approach provided in section 2-718 of the Uniform Commercial Code should be eliminated. Instead of the parties having to fulfill any such requirements, liquidated damages clauses should be presumed to be enforceable. If it can be shown that a clause was a part of the basis of the bargain, then its full enforcement will be consistent with the intentions of the parties and will diminish the need for lengthy litigation on issues of liability and the amount of damages to be awarded. The elimination of the law of liquidated damages can be justified by a theory of efficient penalty. Such a theory would support the use of the doctrine of unconscionability as the best means for policing liquidated damages clauses. Under the doctrine of unconscionability, clauses that are

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substantively and procedurally unconscionable can be voided or reformed. Finally, reformation should be the preferred response in most cases. Instead of the current mandate to void all unreasonable clauses, the courts should attempt to salvage the parties' contractual intent by reforming such clauses.[14]

II. PHILOSOPHICAL FOUNDATIONS OF THE LAW OF LIQUIDATED DAMAGES

Freedom of contract is premised upon the enforcement of contractual intent.[15] Thus, any clause that is the product of private bargaining should be strictly enforced. Contract law will provide relief only when the contract is a product of a process that is not within the private bargaining paradigm. The private bargaining paradigm is premised on the belief that a contract represents the mutual assent of the parties.[16] Contract law's invalidating doctrines of fraud, mistake, and unconscionability have been used when it is apparent that the contract was not a creation of true mutual assent.[17] Economic theory provides an alternative means of justifying the full

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[14] The courts have experience in reforming other clauses, such as covenants not-to-compete, anti-assignment, exculpatory, and satisfaction clauses. *See generally* Larry A. DiMatteo, *The Norms of Contract: The Fairness Inquiry and the "Law of Satisfaction"—A Nonunified Theory*, 24 HOFSTRA L. REV. 349 (1995). Covenants not-to-compete are often reformed to make them reasonable in scope, duration, and geographical coverage. *See generally* Harlan M. Blake, *Employee Agreements Not to Compete*, 73 HARV. L. REV. 625 (1960); Adam Dowd, *Contract Law: Restrictive Covenants Lacking Territorial Limits*, 21 WM. MITCHELL L. REV. 301 (1995); Kevin M. Kelley, *Drafting Enforceable Covenants Not to Compete in Author Publisher Agreements Under New York Law*, 36 UCLA L. REV. 119 (1988).

[15] "The formalities of contract are simply categorizations of objective manifestations that the reasonable person uses as a sound evidentiary base for determining the *intent* and meaning of a contract." Larry A. DiMatteo, *The Counterpoise of Contracts: The Reasonable Person Standard and the Subjectivity of Judgment*, 48 S.C. L. REV. 293, 300 (1997) (emphasis added). *See generally* Robert Braucher, *Freedom of Contract and the Second Restatement*, 78 YALE L.J. 598 (1969).

[16] Section 17 of the Second Restatement states that "the formation of a contract requires a bargain in which there is a *manifestation of mutual assent* to the exchange." RESTATEMENT (SECOND) OF CONTRACTS § 17 (1979) (emphasis added).

[17] Professor P.S. Atiyah has noted that when a contract is heavily one-sided the courts have used limiting doctrines to support the finding that the contract was not a product of true mutual assent. He cites the following examples of the doctrines developed by the law to police such contracts including the "defences of fraud, misrepresentation, and duress and undue influence; . . . mistake and even frustration." P.S. Atiyah, *Contract and Fair Exchange*, 35 U. TORONTO L.J. 1, 2 (1985).

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enforcement of contracts. Contracts should be enforced because private bargaining is an efficient means to maximize wealth.[18] It assumes that the contract is a product of bargaining between fully informed, rational parties.[19] The law's invalidating doctrines can be justified under economic theory because they are utilized when the parties are not fully informed or acting rationally.[20] The law of liquidated damages is an exception to the above rationales for the enforcement of contracts. Even if it can be proven that parties of relatively equal bargaining power intend to agree on a penalty clause, the law of liquidated damages prohibits its enforcement.[21] One curious argument that has been put forward in order to conform the law to freedom of contract is that non-enforcement is a reflection of the parties' *true* intent. This argument will be addressed in the next subsection.

In contrast to the non-enforcement of penalty clauses, the motivating force behind the enforcement of *reasonable* liquidated damages clauses is the parties' intent to provide *just compensation*.[22] If the intent of the clause is to provide just compensation to the non-breaching party, then it should be enforced.[23] However, if the

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[18] Contract scholars have long recognized the idea of wealth maximization. *See, e.g.*, Morris R. Cohen, *The Basis of Contract*, 46 HARV. L. REV. 553 (1933). "[A] regime in which contracts are freely made and generally enforced gives greater scope to individual initiative and thus promotes the greatest wealth of a nation." *Id.* at 562-63.

[19] The concept of contractual freedom has been premised on the rational, fully informed bargaining paradigm. "In an arm's length transaction between two parties who both possess roughly the same amount of knowledge and who are not coerced into making the bargain, economic efficiency will almost always result; otherwise, the parties would not have entered into the contract." David Brizzee, Note, *Liquidated Damages and the Penalty Rule: A Reassessment*, 1991 BYU L. REV. 1613, 1615.

[20] "Absent some type of unconscionable behavior such as duress, a contractual provision that has been freely bargained between two equal parties at arms' length generally benefits the bargaining participants as well as third parties." *Id.*

[21] The court in *In re A.J. Lane & Co.* states:

> Provisions for liquidated damages have been subject to judicial scrutiny for over five centuries, beginning with the exercise by the courts of chancery of equity powers against penalties. Relief is afforded even when the transaction is fully voluntary and the parties have equal bargaining power.

113 B.R. 821, 828 (D. Mass. 1990).

[22] Just compensation means that in a breach of contract claim "justice requires nothing more than compensation measured by the amount of harm suffered." ARTHUR CORBIN, CONTRACTS § 1057 (1964).

[23] *Id.*

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amount stipulated provides a windfall then it cannot be justified under the just compensation principle that underlies common law contract damages.[24] Professor Corbin states that "[contractual] justice requires nothing more than compensation measured by the amount of harm suffered."[25] The just compensation principle can be seen at work in some courts' recognition of the "no injury defense."[26] This defense allows a court to invalidate an otherwise reasonable liquidated damages clause when the breaching party proves that the other party sustained no actual injury. Just compensation dictates that the plaintiff show actual, foreseeable harm. It is the fundamental philosophical influences of the principles of freedom of contract and just compensation that the law of liquidated damages is intended to advance. Any rational change in the current law must attempt to accommodate both of these influences.

A. *Freedom of Contract and Just Compensation*

Under the rationale of the common law's adequacy of consideration doctrine, courts are given the negative obligation to not evaluate the adequacy or relative equality of the considerations being exchanged. A logical extension of this doctrine is that courts should also refrain from judging the adequacy of the remedy prescribed by agreement.[27] It should be up to the parties to negotiate the terms of the provision—both the amount of the penalty and the circumstances upon which it is to be triggered. It is not for the courts to relieve a party of the burdens of a freely negotiated clause. The one exception to the adequacy of consideration principle is the Uniform Commercial Code's doctrine of unconscionability. However, the unconscionability doctrine requires that a term reflect both procedural and substantive unconscionability. In contrast, the law of

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[24] The court in *Jaquith v. Hudson*, 5 Mich. 123 (1858), stated that contract law "will not permit the parties by stipulation, . . . however clear the intent, to set [the just compensation principle] aside." *Id.* at 133.

[25] *Id.*

[26] *Infra* Section III.A.4.

[27] I noted in an earlier article that the law of liquidated damages is an example of the expansion of the "fairness in the exchange paradigm" into the remedial wing of contracts. "Instead of a direct analysis of the contract, the courts may look to the fairness of the damage award from the perspective of the breaching party and the community." Larry A. DiMatteo, *Equity's Modification of Contract: An Analysis of the Twentieth Century's Equitable Reformation of Contract Law*, 33 NEW ENG. L. REV. 265, 280 (1999).

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liquidated damages allows a court to void an express term upon a finding of unreasonableness. No procedural shortcomings need be shown to invalidate a liquidated damages clause.

Classical contract theory, as espoused prior to the enactment of the Uniform Commercial Code and the Restatements of Contracts,[28] was closely associated with the laissez-faire economics notion of freedom of contract.[29] "The whole point of freedom of contract is to reject paternalism and leave the parties to their own bargain."[30] Justice and fairness under the freedom of contract paradigm are party constructed. Justice, when premised as "party constructed efficiency," is not concerned with individual justice or fairness but looks to systemic fairness or efficiency to defend the strict enforcement of one-sided bargains. The systemic efficiency of contract law to facilitate exchange is premised upon the enforcement of harsh as well as relatively equal contractual exchanges. In reality, courts have often, and generally by covert means, interpreted or constructed contracts in certain ways in order to rescue a party from a hard bargain.[31]

P.S. Atiyah has asserted, despite protestations of the impregnability of freedom of contract, that courts have always concerned themselves with the substantive fairness of exchange.[32] The statutory mandate, provided by Section 2-718 of the Uniform Commercial Code, to void unreasonable liquidated damages clauses is a further extension of the fairness of the exchange concerns found in the common law. Prior to

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[28] The Second Restatement states:

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

RESTATEMENT (SECOND) OF CONTRACTS § 356(1) (1979). The Second Restatement copied verbatim the liquidated damages provision found in Section 2-718(1) of the Uniform Commercial Code.

[29] "[T]he shibboleths of *freedom of contract* and *sanctity of contract* became the foundations on which the whole law of contracts was built[;] that it was just to enforce contractual duties strictly according to the letter." ATIYAH, *supra* note 6, at 9.

[30] P.S. ATIYAH, ESSAYS ON CONTRACTS 361 (1986); *see also* Anthony Kronman, *Paternalism and the Law*, 92 YALE L.J. 763 (1983); Rochelle Spergel, *Paternalism and Contract: A Critique of Anthony Kronman*, 10 CARDOZO L. REV. 593 (1988).

[31] *See generally* DiMatteo, *supra* note 14.

[32] *See generally* P.S. Atiyah, *supra* note 17; P.S. ATIYAH, THE RISE AND FALL OF FREEDOM OF CONTRACT (1976).

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the codification of the non-enforceability of liquidated damage *qua* penalty clauses, the courts often voided such provisions under the fictions of fraud and mistake. Atiyah labeled such reasoning as the conclusive presumption of unfairness:

> [W]e examine the case with a strong presumption that a sufficiently unfair contract must have been the result of improper procedures. . . . Suppose a contract in which the outcome favors one party vastly more than the other; our natural reaction is to believe that something must have gone wrong with the bargaining process. How could a rational person have entered into this contract if he . . . had not been subject to undue pressures, or the like?[33]

The just compensation principle has often been used as the judicial rationale for voiding liquidated damages clauses.[34] The just compensation principle is based upon the belief that the innocent party is only due compensatory damages in order to protect his expectancy interest. Therefore, "parties should not be allowed to recover more than just compensation from the courts through a privately concocted alternative arrangement."[35] The Supreme Court of Ohio declared that "reasonable compensation for actual damages is the legitimate objective of such liquidated damage provisions and where the amount specified is manifestly inequitable and unrealistic, courts will ordinarily regard it as a penalty."[36]

1. *Justice as Party Constructed Efficiency*

Lord Diplock advanced the view of freedom of contract as party constructed efficiency over three decades ago in *Robophone Facilities Ltd. v. Blanck.*[37] His argument for the enforcement of liquidated

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[33] ATIYAH, *supra* note 30, at 334.

[34] *See, e.g.*, Truck Rent-A-Center, Inc. v. Puritan Farms, 261 N.E.2d 1015 (Ct. App. 1977). "A liquidated damage provision has its basis in the principle of just compensation." *Id.* at 1018.

[35] Goetz & Scott, *supra* note 8, at 560.

[36] Samson Sales, Inc. v. Honeywell, Inc., 465 N.E. 2d 392, 393-95 (Ohio 1984); *see also* Sheffield-King Milling Co. v. Domestic Science Baking Co., 115 N.E. 1014 (Ohio 1917).

[37] [1966] 1 WLR 1428.

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damages clauses anticipated the advent of law and economics analysis to support the strict enforcement of contracts:

> It is good business sense that parties to a contract should know what will be the financial consequences to them of a breach on their part, for circumstances may arise when further performance of the contract may involve them in loss.
>
> The more difficult it is likely to prove and assess the loss which a party will suffer in the event of a breach, the greater advantages to both parties of fixing the terms of the contract itself an easily ascertainable sum to be paid in that event. Not only does it enable the parties to know in advance what their position would be if a breach occurs as to avoid litigation at all, but, if litigation cannot be avoided, it eliminates what may be the very heavy legal costs of proving the loss actually sustained which would have to be paid by the unsuccessful party. The court should not be astute to decry a *penalty clause* in every position of the contract which stipulates a sum payable by one party to the other in the event of a breach by the former.[38]

The use of economic theory to support the elimination of the law of liquidated damages will be more fully explored later in this article.[39]

Professor Atiyah offers a somewhat counter-intuitive argument that the non-enforcement of a penalty clause actually serves to advance the intent of the contracting parties. He asserts that contracting parties will insert clauses that they do no intend to enforce. He gives the penalty clause as a prime example. "[N]obody wishes, ex ante, that the clause should ever be enforced. The purpose of a penalty clause is to bring pressure, to threaten, and if the contract is broken anyhow, the clause has failed of its purpose."[40] This argument would have some credibility if one assumes that the contracting parties are familiar with the default rule voiding penalty clauses. However, if the parties are unfamiliar with the subtle nuances of liquidated damages law, then the intentional insertion of a clause that is not to be enforced is difficult to accept. Of course, if penalty clauses were routinely enforced, then the argument that the parties intended non-enforcement would be even weaker. A more rational approach is to

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[38] As quoted in Kevin Hoy, *Penalties and Liquidated Damages Clauses in England and Ireland*, *in* STRUCTURING INTERNATIONAL CONTRACTS 243, 250-51 (Dennis Campbell ed., 1996).

[39] *Infra* Sections IV. B. & C.

[40] ATIYAH, *supra* note 30, at 369.

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argue that the parties do not *expect* that they will need to enforce the clause. But, this may be said of many of the clauses found in contracts, such as those dealing with issues of default or dispute settlement. However, these clauses are routinely enforced despite the parties' expectation that they would not be used. Contracting parties generally contemplate the profit to be made by the amicable completion of their contractual marriage. Clauses centering on the dissolution of the profit-making enterprise are generally given less attention.[41]

2. *Justice as Substantive Equality and Equity*

The just compensation principle mandates that the non-breaching party is to receive expectancy damages.[42] The corollary principle,

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[41] Two exceptions are clauses that reference dissolution or breach of contract including liquidated damages clauses and letter of credit or performance bond provisions. In some cases, letters of credit, bonds, or bank guarantees are used to "fund" liquidated damages or penalty clauses. For example, in international trade, counterpurchase agreements will generally provide for liquidated damages or penalties and, at times, are guaranteed by third-parties. "The Western exporter generally will be required to obtain a bank guarantee providing for the payment of penalties in the event the exporter does not perform its counterpurchase obligations." Kaj Hober, *Countertrade: Negotiating Terms, Part II*, 6 INT'L FIN. L. REV. 17 (1987). Can a liquidated damages clause be supported by a letter of credit or bond? That is, does the non-enforceability of the liquidated damages clause render the letter or credit or bond inoperative? The answer seems to be in the affirmative. *See, e.g.*, Hubbard Bus. Plaza v. Lincoln Liberty Life Ins. Co., 649 F. Supp. 1310 (D. Nev. 1986). Performance bonds and letters of credit are often used to guarantee performance. A failure to fully or timely perform will generally trigger an automatic payment of a lump sum of money, often unrelated to the actual damages incurred. These instruments, which are negotiated with third parties, are universally accepted and enforced. Despite the third-party nature of these instruments, the ultimate liability rests with the underlying parties to the contract. Aren't the same dangers present, as in the law of liquidated damages, that the lump sum payment may amount to a penalty? If so, why aren't similar tests of enforceability, as found in the law of liquidated damages, applied to such transactions? Shouldn't the bond or letter of credit amount be a good faith estimate of the damages likely to be incurred in the event of a breach? Shouldn't such obligations be voided if the amount payable is disproportionate to the damages suffered by the beneficiary party? Why is the non-beaching party's right to demand payment on a bond or letter of credit so different than its right to claim liquidated damages?

[42] Professor Farnsworth explains why just compensation in the common law system has generally been defined as the granting of expectancy damages:

> How can men be encouraged to deal with those who make promises? The answer given by our legal system is : By protecting their expectations in the event of breach. The principle objective of the system, once breach has occurred, is to put the

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what will be called here the *equality of damages* principle, can be seen as the impetus for the rules against penalties and punitive damages. Penalties and punitive damages are considered supracompensatory and thus are not protected under the just compensation principle. The corollary principle maintains that an equitable legal remedy is one that equates actual damages to the damages awarded. The problem with this notion of *equality of damages* is the difficulty of determining actual damages with the necessary degree of certainty.[43] The result is a built-in bias against awarding damages that *may* result in overcompensation.[44] Thus, the law is slanted in favor of awarding less then full damages. First, a number of *actual* damage items are generally not given.[45] These include attorney fees and prejudgment interest. The time value of money and the substantial costs of litigation result in an immediate discounting of the value of most damage awards. Second, the non-pecuniary human costs represented by inconvenience and emotional distress, along with the additional transaction costs of finding another contracting partner, are generally ignored under common law damages.[46] This non-recognition of certain actual damages challenges the notions of the efficiency and fairness of common law damages. If common law damages are seen

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> promisee in the position in which he would have been had the promise been performed . . . . This is accomplished by giving the promisee relief based on the disappointment in his expectations . . . .

Farnsworth, *supra* note 7, at 1147-48.

[43] Damages must have been reasonably foreseeable under the rules of *Hadley v. Baxendale* and reasonably certain. The certainty principle is presented in RESTATEMENT (SECOND) OF CONTRACTS § 352 (1981) ("Damages are not recoverable for loss beyond an amount that the evidence permits to be established with reasonable certainty."); *see also* Elmer J. Schaefer, *Uncertainty and the Law of Damages*, 19 WM. & MARY L. REV. 719 (1978).

[44] "The traditional rules establish full compensation as the maximum potential recovery for a contract plaintiff, and they impose the primary risk of error in calculating damages on the aggrieved plaintiff rather than upon the breacher; thus they often preclude realizing full compensation." John A Sebert, Jr., *Punitive and Nonpecuniary Damages in Actions Based Upon Contract: Toward Achieving the Objective of Full Compensation*, 33 UCLA L. REV. 1565, 1567-68 (1986).

[45] "[E]xpectation damages as awarded in law often fall short of a truly compensatory measure due to the exclusion of such items as attorneys' fees, unmeasurable subjective losses, and *unforeseeable* damages." Craswell, *supra* note 8, at 637 (emphasis in original). The rule in which the prevailing party pays for its own attorney fees is known as the "American rule." For a history of the American rule see Symposium, *Attorney Fee Shifting*, 47 LAW & CONTEMP. PROBS. 1 (1984).

[46] *See generally* Sebert, *supra* note 44, at 1567-68.

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as inefficient, then the concept of efficient breach becomes less compelling. The Pareto-superior basis for efficient breach is shattered if one believes that the common law of damages systemically under-compensates the non-breaching party.[47] The non-breaching party is better off if the other party performs than by receiving the compensatory damages provided for under the common law of contracts. Thus, the pending breach should be considered as inefficient. The efficiency arguments for and against the enforcement of penalty clauses will be more fully addressed in Part IV.

One can argue that penalty clauses are a means of avoiding contract law's general prohibition against the awarding of punitive damages.[48] Viewing penalties as punitive damages introduces the notion of *badness* into the enforcement decision. Traditionally, the badness aspect was confined to an analysis of the purpose of the clause.[49] If the non-breaching party's purpose was to induce or coerce performance, then the purpose was improperly punitive in nature. If the purpose was to justly compensate the non-breaching party, then the clause was the product of proper intent. However, badness can also be viewed from the perspective of the breaching party. This perspective focuses upon the badness of the breaching party's motive for breaching. One may argue that involuntary breach does not possess the element of badness. However, an opportunistic breach may be labeled as stemming from a bad motive. Of course, efficient breach theory[50] would hold otherwise. A breach is judged solely on whether it is efficient and not on the motive of the breaching

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[47] *Id.* at 1566-84. Professor Sebert makes this argument in arguing "for a broader and more overt recognition of both nonpecuniary loss and punitive or supracompensatory damages in contract." *Id.* at 1570; *see also* Daniel A. Farber, *Reassessing the Economic Efficiency of Compensatory Damages for Breach of Contract*, 66 VA. L. REV. 1443 (1980); Dawson, *General Damages in Contract for Non-Pecuniary Loss*, 10 NEW ZEALAND U. L. REV. 232 (1983).

[48] *See, e.g.*, Garrity v. Lyle Stuart, Inc., 353 N.E.2d 793 (N.Y. 1976) (arbitrator's award of punitive damages for a breach of contract violates public policy); *cf.* Romero v. Mervyn's, 784 P.2d 992 (N.M. 1989) (punitive damages may be awarded for a breach of contract in cases of malice, fraud, or oppression).

[49] The "badness" aspect of a liquidated damages clause refers to when the clause is intended not so much to compensate the non-breaching party, but to deter the other party from breaching in the first place. "Occasionally nonbreachers have argued that stipulated [liquidated damages] clauses should be enforced as a deterrent to breach of contract. Courts have rejected this argument as inconsistent with the just compensation principle." Clarkson et al., *supra* note 8, at 358 n.29.

[50] *Infra* Section IV.A.

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party. Economic efficiency arguments aside, one may argue that the punitive nature of a penalty may be justified in order to deter bad faith breach.[51] Involuntary breaches cannot be deterred and therefore should not be punished. In contrast, an opportunistic breach may be deterred by the enforcement of a penalty clause.[52] General contract remedies and the law of liquidated damages, nonetheless, have traditionally rejected all attempts to award punitive damages. However, the modern innovation of the tort of bad faith breach has made punitive damages available for certain types of breach. Generally, tort damages for a breach of contract are confined to instances beyond mere opportunism.[53] This includes breaches in which the breaching party fails to compensate the non-breaching party.[54] Efficient breach theory recognizes opportunistic breaches that provide for the full compensation of the non-breaching party.[55] Efficiency would still argue against awarding punitive damages for bad faith in failing to compensate the non-breaching party.[56] The breaching party can simply be made, through litigation, to compensate the non-breaching party through an award of non-punitive contract damages.[57]

The recognition of the tort of bad faith pertaining to a contract that contains a penalty clause provides an interesting case study. Assum-

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[51] *Cf.* Dorsey D. Ellis, Jr., *Fairness and Efficiency in the Law of Punitive Damages*, 56 S. CAL. L. REV. 1 (1982).

[52] I will argue in the alternative in *infra* Section IV.B.

[53] Professor Sebert lists the following examples where tort damages have been given for breach of contract: intentional misrepresentation, conversion, forgery, and tortious interference with business relationships. Sebert, *supra* note 44, at 1601-03.

[54] A classic example of non-payment is the so-called insurance cases where insurance companies failed to pay legitimate coverage claims. *Id.* at 1613-28.

[55] "[A]n *efficient breach* of contract [is one] in which although the breacher breaches knowingly, he voluntarily compensates the other party." W. DAVID SLAWSON, BINDING PROMISES: THE LATE 20TH CENTURY REFORMATION OF CONTRACT LAW 114 (1996).

[56] Efficient breach theory holds that as long as the non-breaching party receives compensatory damages by a court, then there is no need for punitive damages. "[T]he theory of efficient breach incorrectly assumes that the plaintiff can be made whole when the court awards expectancy damages." Warkol, supra note 8, at 349. Furthermore, "[imposing liability beyond] expectancy would extinguish the economic incentive to pursue more profitable ventures, thereby inhibiting breaches of inefficient agreements." *Id.* at 324 (quoting Frank J. Cavico, Jr., *Punitive Damages for Breach of Contract – A Principled Approach*, 22 ST. MARY'S L.J. 357, 371 (1990)).

[57] *Id.*

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ing that the contract that is the subject of the bad faith breach contains a penalty clause, the non-breaching party is provided two opportunities to recover *supercompensatory* damages. First, it can attempt to seek punitive damages under tort law. The party may instead seek to enforce the penalty clause. This avenue will likely be fruitless because of the law of liquidated damages rejection of all penalty clauses. This per se treatment of penalty clauses is unfortunate. It would be more just and efficient to enforce the contracting parties' quantification of punitive damages as represented by the penalty clause. Instead, the non-breaching party is forced to litigate under tort law and seek a judicial imposition of punitive damages. This may indeed be the more lucrative avenue of redress for the non-breaching party, but it may not be the best result from an efficiency or contractual justice perspective. One alternative would be to create an exception in the law of damages that would allow courts to enforce a penalty clause as an alternative to awarding punitive damages for the tort of bad faith.[58]

B. *International Law Comparison*

A review of the treatment of liquidated damages clauses under foreign legal systems will provide a benchmark for comparing the rationality of American law.[59] In terms of efficiency, an analysis of

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[58] Another argument for the enforcement of penalty clauses or the awarding of punitive damages for breach of contract is that such enforcement is permitted in the area of arbitration. The Supreme Court has recognized the ability of arbitrators to award punitive damages despite the fact that the substantive law of New York reserves that right to the courts. *See* Mastrobuono v. Shearson Lehman Hutton, Inc., 115 S. Ct. 1212 (1995); *cf.* Garrity v. Lyle Stuart, Inc., 353 N.E.2d 793 (N.Y. 1976). The Court seemed willing to enforce an arbitral award of punitive damages when the parties have agreed that such an award is in the power of the arbitrator. Since public policy is the primary reason for the voiding of such awards, then should not the same public policy prevent the delegation of such authority to an arbitral panel? If not, then why should not the enforcement of penalty clauses by an arbitral panel be treated any differently? Finally, if enforceable by arbitral panels because of the power of the parties to create their own private law in their submissions to arbitration, then why shouldn't penalty clauses be enforced by the courts as the parties' pre-agreed law of damages?

[59] Of course, we need not leave the United States to conduct a comparative analysis. Louisiana law generally gives contracting parties the unqualified right to stipulate any amount of liquidated damages. *See, e.g.*, Pembroke v. Gulf Oil Corp., 454 F.2d 606 (1971) (courts will not inquire into whether the actual damages suffered approximate the stipulated amount).

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several legal systems' approaches to a given area of law provides a real world laboratory to measure relative efficiencies of the different approaches.[60] This section will focus on comparing some of the substantive differences in liquidated damages law among different legal systems. Limiting the courts to rescission of the liquidated damages clause *qua* penalty is a minority approach under most national laws. A Council of Europe study noted that only the countries of England and Belgium (within Europe) prohibit their courts from rewriting penalty clauses.[61] In contrast, it cites Article 1152 of the French Civil Code that confers "a wider power on the courts to reduce penalties . . . and allows reduction to take place even if the penalty is not *manifestly excessive*."[62] In order to provide some uniformity between the common law's concept of penalty and the civil law, which tends not to scrutinize liquidated damages clauses, the Council of Europe adopted Resolution (78) 3 on Penal Clauses in the Civil Law.[63] The Resolution adopts language akin to the nomenclature of unconscionability. It provides for "judicial control over penal clauses . . . where the penalty is *manifestly excessive*."[64] The Resolution also provides for the reformation of such clauses. It states that the "sum stipulated may be reduced by the court when it is manifestly excessive."[65] In its Explanatory Memorandum, the Committee on Legal Co-operation explained that some penal clauses are "*stricto sensu* whose main purpose [is] to act as a threat to induce the promisor to perform" while others are "a genuine pre-assessment of damages . . . or liquidated damages."[66] However, unlike in the common law, the clauses that are *stricto sensu* are not invalid per se

[60] The idea of using comparative law analysis to measure economic efficiency in explaining legal change was described in an article by Professor Mattei. Ugo Mattei, *Efficiency in Legal Transplants: An Essay in Comparative Law and Economics*, 14 INT'L REV. L. & ECON. 3 (1994).

[61] Courts are required simply "to set aside a clause which is found to impose a true penalty." COUNCIL OF EUROPE, PENAL CLAUSES IN CIVIL LAW 15 (1978).

[62] *Id.* (emphasis in original) (language taken from Resolution (78) 3 on Penal clauses in Civil Law, Council of Europe).

[63] Adopted by the Committee of Ministers on January 20, 1978 at the 281st Meeting of the Ministers' Deputies.

[64] *Id.* at preamble (emphasis added); *see also id.* art. 7.

[65] *Id.* art. 7.

[66] *Id.* at explanatory note 6.a. & b.

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under a majority of national laws.[67] In short, it is acceptable for a liquidated damages clause to serve not only as a means for just compensation, but also as an incentive to induce performance.[68]

Resolution (78) 3 provides a list of factors for determining if liquidated damages are "manifestly excessive." These factors include: the comparison of the pre-estimated damages with the actual damages suffered, "the legitimate interests of the parties including the promisee's *non-pecuniary* interests, the category of the contract and the circumstances under which it was concluded, in particular the relative social and economic position of the parties ... or the fact that the contract was a standard form contract," and whether the breach was in good or bad faith.[69] Three distinctions can be made regarding the inherent differences of Continental European and American law. First, the European threshold for voiding a liquidated damages clause is much higher than what is found in American law. The amount of damages must be more than merely disproportionate to actual damages; they must be "manifestly excessive." Second, the language of unconscionability is readily apparent in the law of Continental Europe. "Manifestly excessive" can be used as a synonym for substantive unconscionability. Also, the factors given for reviewing liquidated damages clauses include those often associated with procedural unconscionability including "the relative social and economic position of the parties" and the use of a standard form contract. Finally, the notion of *non-pecuniary interests* is especially noteworthy. This idea can be used to offset a less than accurate pre-

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[67] "[I]n a small number of member states a penal clause *stricto sensu* was either void or would not be enforced by the courts . . . while the laws of all other member states allowed such clauses." *Id.* at n.8.

[68] *See, e.g.*, United Nations Commission on International Trade Law, *Legal Guide on Drawing Up Contracts for the Construction of Industrial Works, at* http://www.un.ot.at/uncitral/English/texts/contruc/lgconstr.htm (1987). It states that under some legal systems "clauses under which the agreed sum serves as compensation, *or is intended to stimulate performance*, or has both functions, are valid." *Id.* at Chapter XIX (emphasis added). It further states that "if the applicable law permits, the purchaser may find it beneficial to provide for an agreed sum in an amount which . . . puts a moderate pressure on the contractor to perform." *Id.*

[69] COUNCIL OF EUROPE, *supra* note 61, Res. 78(3) on Penal Clauses in Civil Law (1978), Paragraph 26, Explanatory Memorandum (Commentary to Article 7).

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estimate of damages, that is, one that is substantially disproportionate to actual damages.[70]

A review of foreign national laws demonstrates that the common law approach to liquidated damages is not the only viable alternative. For example, the Foreign Contract Law of the People's Republic of China[71] does not deal directly with the issue of liquidated damages, but allows for the use of deposits as a way of fixing damages unrelated to actual damages. Article 14 of the law allows a party to retain the deposit if the other party fails to perform. Alternatively, if the party holding the deposit fails to perform, then it must return twice the amount of the deposit.[72] This concept of deposit forfeiture mimics the doctrine of *arrhes* found in Section 1590 of the French Civil Code.[73] Under the doctrine of *arrhes* a deposit is forfeited when the deposit giver cancels a contract. If the deposit holder cancels the contract, then that party must refund twice the amount of the deposit. The rules embodied in the doctrine of *arrhes* can be understood as the use of deposits as liquidated damages. Furthermore, the potentially penal nature of retaining the entire deposit or the doubling of the amount refunded is disregarded under this doctrine.

The French Civil Code deals directly with the issue of liquidated damages or penalty clauses. Article 1152 of the French Civil Code allows the courts to provide alternative relief if the stipulated amount is "manifestly excessive."[74] It expressly grants courts the authority to reduce or increase the penalty if it is deemed to be manifestly excessive or low. In Japan, there is a strong presumption that penalty

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[70] This idea of non-pecuniary damages or costs will be examined in the section on the economic theory of liquidated damages *infra* Section IV. B.3.

[71] *See generally* Zhang Yuqing & James S. McLean, *China's Foreign Economic Contract Law: Its Significance and Analysis*, 8 NW. J. INT'L L. & BUS. 120 (1987).

[72] LAW OF THE PEOPLE'S REPUBLIC OF CHINA ON ECONOMIC CONTRACTS INVOLVING FOREIGN PARTIES (FOREIGN ECONOMIC CONTRACTS LAW).

[73] Section 1590 of the French Civil Code states:

> If the promise to sell was made with payment of a deposit (*arrhes*), each of the contracting parties is at liberty to withdraw. The one who paid the deposit, on forfeiting it, and the one who received it, on returning double the amount.

[74] INTERNATIONAL CHAMBER OF COMMERCE, GUIDE TO PENALTY AND LIQUIDATED DAMAGES CLAUSES 31 (1990) (hereinafter "ICC GUIDE").

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clauses are enforceable,[75] but Article 420(1) of the Japanese Civil Code precludes a court from reforming the contract amount.[76] The laws of Denmark, Sweden, Finland, and Norway allow either the voiding or reformation of a penalty clause deemed to be unreasonable. Swedish law specifically provides for an evaluation of the relative bargaining power of the parties in making the reasonableness determination. Section 36(2) of the Swedish Commercial Code provides that "particular consideration" shall be given to protecting the party "in a subordinate position in the contractual relationship."[77] The Swiss Code of Obligations deals directly with the "no actual damages defense."[78] Article 61(1) provides that payment of the penalty is due "even if in the actual case the promisee has not suffered any damage."[79] The Russian Civil Code also provides that "the debtor must pay the penalty established for the breach regardless of whether or not the creditor has suffered damages as a result of the breach."[80] However, Article 190 of the Code allows a court to reduce the amount of the penalty or liquidated damages if it is "extraordinarily large in comparison with the creditor's actual losses."[81] In contrast, Anglo-American common law simply allows for the voiding of a penalty clause and the assessment of actual damages when the stipulated amount is considered unreasonably large.

III. The Sanctioned Chaos of the Law of Liquidated Damages

The tension between the need to acknowledge the equities of each case and the dictates of freedom of contract rationales has resulted in a chaotic jurisprudence in the area of liquidated damages. There exists an historical sensitivity to such clauses which dates back to their predecessors, the old English penal bonds. Penal bonds were generally enforced when due even in the event that no actual

[75] Article 420(3) of the Japanese Civil Code states that "a penalty clause is presumed to be a determination in advance of the amount of compensation due for damages." ICC Guide, *supra* note 74, at 37.

[76] *Id.*

[77] *Id.* at 38.

[78] *Infra* Section III.A.4.

[79] ICC Guide, *supra* note 74, at 43.

[80] *Id.* at 50.

[81] *Id.* at 51.

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damages were sustained.[82] Does the current tripartite approach encapsulated in Section 2-718 of the Uniform Commercial Code adequately serve its intended goal of preventing awards of penal or punitive damages or does it cut an overly broad path through freedom of contract, canceling non-punitive risk allocations as well as punitive performance enhancing clauses? This Part will analyze the law of liquidated damages as it has evolved in the common law and in its enactment in the Uniform Commercial Code.

A. *The Law of Liquidated Damages*

The highest court of New York in an 1854 case summarized the law of liquidated damages as one in which the "ablest judges have declared that they felt themselves embarrassed in ascertaining the principle on which the decisions . . . were founded."[83] The confused state of liquidated damages law was further recognized in the 1917 case of *Giesecke v. Cullerton*[84] where the court stated that "[n]o branch of law is involved in more obscurity by contradictory decisions than whether a sum specified in an agreement to secure performance will be treated as liquidated damages or a penalty."[85] In reading more recent cases, one may conclude that nothing much has changed. First, the law of liquidated damages fails to adequately rationalize why such clauses are to be treated differently than other contract provisions that may be equally unfair or one-sided. For example, it fails to explain why liquidated damages clauses cannot be policed under the general doctrine of unconscionability. An often-stated rationale is that clauses that are a good faith attempt to estimate damages should benefit from a presumption of enforceability. In the alternative, clauses that are intended to encourage performance are deemed as penal in nature and unenforceable.[86] Why shouldn't

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[82] *See generally* 3 SAMUEL WILLISTON, CONTACTS (1920). *See, e.g.,* Fletcher v. Dyche, 100 Eng. Rep. 18 (1787).

[83] Cotheal v. Talmage, 9 N.Y. 551, 553 (1854).

[84] 117 N.E. 777 (Ill. 1917).

[85] *Id.* at 778; *see also* Pick Fisheries, Inc. v. Burns Elec. Security Serv., Inc., 342 N.E.2d 105, 108 (Ill. App. 1976) ("there is much contradiction in the case law regarding the distinction between a valid liquidated damages clause and an unenforceable penalty").

[86] The intention of the parties test can be summarized as such: "Whether the parties intended a preagreed damages clause to operate in lieu of, rather than compel, performance . . ." Note, *supra* note 8, at 1061. If the parties intended the latter then the clause is an

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parties be able to provide such incentives to encourage performance? If the incentive is not unduly harsh, why does it need to be an estimate of damages? At least in a scenario where the clause was fully negotiated among relatively sophisticated parties, shouldn't the anticipated-actual damage requirements be loosened? Second, the law of liquidated damages fails to clearly explain the difference between a reasonable liquidated damage clause and one that is a penalty. The cases often seem to reflect a number of prejudices including a judicial propensity not to enforce such clauses and the use of semantics within contracts to avoid the need to apply the cumbersome requirements for liquidated damages. For example, the classification of pre-agreed damages as late charges or discounts has at times been sufficient to ensure enforceability.[87]

1. *Single-Pronged Approach*

The early common law approach to liquidated damages clauses focused upon the intentions of the parties. The courts simply asked what was the parties' intended purpose of inserting the clause into the contract?[88] The single-pronged approach or intentions approach analyzes the intentions of the parties regarding the meaning and purpose of the liquidated damages clause.[89] If the parties intended the clause to be punitive in nature, then it should not be enforced. If the parties viewed the clause as a reasonable alternative to litigation (a good faith attempt to estimate damages), then it should be enforced.

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unenforceable penalty. "[T]he parties must have intended to create liquidated damages, not a penalty." *Id.*

[87] *See, e.g.*, Sweet, *supra* note 7, at 90-91.

[88] "Courts will look to the intention of the parties to make an accurate assessment of the clause's purpose." *In re* Dailey, 167 B.R. 932, 933 (D. Mont. 1994); *see also* Underwood v. Sterner, 63 Wash. 2d 360, 366, 387 P.2d 366 (1963); Management, Inc. v. Schassberger, 39 Wash. 2d 321, 326-27, 235 P.2d 293 (1951).

[89] *See, e.g.* Brecher v. Laikin, 430 F.Supp. 103 (S.D.N.Y. 1977).

> As a general test, if a contested clause providing for definite preagreed damages is intended by the parties to operate in lieu of performance, it will be deemed a liquidated damages clause and may be enforced by the courts. If such a clause is intended to operate as a means to compel performance, it will be deemed a penalty and will not be enforced.

Id. at 106.

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This approach fits nicely into the freedom of contract paradigm that is premised upon the enforcement of the parties' intent as represented by their contract.[90] A liquidated damages clause, when formulated as just compensation, is a firm part of the bargain by which both parties intend to be bound. In contrast, the liquidated damages clause *qua* penalty is not within the parties' zone of expectations regarding the possible conclusions of their contract and thusly, is not a true reflection of the parties' intent. P.S. Atiyah asserts that this party-focused finding of "non-intent" is the practical grounding for the common law's refusal to enforce the penalty clause. "So it seems that the common law's traditional refusal to enforce penalty clauses shows an intuitive understanding that such clauses are not genuine contractual promises or obligations. They are fakes, masquerading as contractual promises."[91] The penalty clause's primary purpose is not realized in its enforcement but instead in providing pressure on a party to fully perform.[92]

Under this approach it would seem that proof of actual damages grossly disproportionate to the stipulated sum would be immaterial. Furthermore, the intention standard would preclude a defense of "no actual injury."[93] The fact that the plaintiff was indeed not injured by the breach is immaterial to a finding that the clause was intended to provide compensation for anticipated harm. That was the issue which confronted Learned Hand in *Frick Co. v. Rubel Corp.*[94] In this case the defendant was precluded from providing evidence that the loss actually incurred was "infinitesimally small as compared to the penalty."[95] The court upheld the preclusion because a gross disparity between the stipulated amount and the actual damages was

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[90] "Intention is regarded as the keystone of contract law." JOHN D. CALAMARI & JOSEPH M. PERILLO, THE LAW OF CONTRACTS 8 (3d ed. 1987); *see also* E. Allan Farnsworth, *The Past of Promise: An Historical Introduction to Contract*, 69 COLUM. L. REV. 576, 577 (1969); Roscoe Pound, *The Role of the Will in Law*, 68 HARV. L. REV. 1, 3 (1954).

[91] ATIYAH, *supra* note 30, at 369.

[92] "[T]he enforcement of a penalty clause is never one of the primary purposes of the contract, and nobody wishes, *ex ante*, that the clause should ever be enforced. The purpose of a penalty clause is to bring pressure, to threaten, and if the contract is broken, the clause has failed of its purpose." *Id.*

[93] *See infra* Section III.A.5. ("No Actual Injury Defense").

[94] 62 F.2d 765 (2d Cir. 1933).

[95] *Id.* at 767.

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immaterial to the enforcement issue.[96] Thus, the focus is solely on the state of mind of the parties at the time of formation and does not involve any retrospective comparison to actual damages.

2. *Two-Pronged Approach*

The common law often looked at other factors to provide guidance in determining the parties' intended purpose for inserting the liquidated damages clause into the contract. First, courts asked whether at the time of formation the liquidated damage amount was a reasonable estimate of future damages. Second, courts asked a seemingly contradictory question of whether the damages were incapable of being estimated or proved. The court in *Ashley v. Dilworth*[97] described the two-pronged approach under Missouri law. "In order that a liquidated damages clause be valid: (1) the amount fixed as damages must be a reasonable forecast for the harm caused by the breach; and (2) the harm that is caused by the breach must be of a kind difficult to accurately estimate."[98] The degree to which the stipulated damages are disproportionate to the actual damages incurred is immaterial to this approach. The two prongs have been rationalized through the determination that the pre-agreed damage amount is more likely to be found to be a reasonable estimate in cases where such damages are difficult to estimate, or alternatively to prove, at the time of breach.[99] Oddly, liquidated damages clauses

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[96] *Id.* (emphasis in original).

[97] 147 F.3d 715 (8th Cir. 1998).

[98] *Id.* at 714 (citing Southwest Eng'g Co. v. United States, 341 F.2d 998 (8th Cir. 1965); Grand Bissell Towers Inc. v. Joan Gagnon Enter., Inc., 657 S.W.2d 378, 379 (Mo. App. 1983). In Montana, the two-prongs are stated as whether the stipulated damages were a "reasonable forecast of just compensation" and whether the harm was "incapable or difficult of ascertainment." *In re* Dailey, 167 B.R. 932, 933 (D. Mont. 1994). The "[r]easonableness of the forecast will be judged as of the time the contract was entered." *Id.*; *see also In re* A.J. Lane & Co., 113 B.R. 821 (D.Mass. 1990); Northwest Acceptance Corp. v. Hesco Constr., 26 Wash. App. 823, 829, 614 P.2d 1302 (1980). A bank's prepayment clause was held to be an unenforceable penalty mainly because of the ease of determining proof of loss. "The damage formula is simple and well established. It is the difference in the interest yield between the contract rate and the market rate at the time of prepayment, projected over the term of the loan and then discounted to arrive at present value." 113 B.R. at 829.

[99] The court in *In re A.J. Lane & Co, Inc.*, 113 B.R. 821 (Bkrtcy. D. Mass. 1990) cited Section 356, comment b. for this interrelationship: "The greater the difficulty of either

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would not be valid in a case where such damages would be easy to calculate in the future. This requirement is the most difficult to rationalize. Shouldn't parties be able to agree to pay foreseeable damages in their contract as an alternative to having to prove them in future litigation?

3. *Three-Pronged Approach*

Section 2-718 of the Uniform Commercial Code eliminated the "intentions test" in favor of a tripartite approach.[100] First, it provides a twin test of reasonableness. It requires that the damage provision be a reasonable estimate of anticipated damages "*or* actual harm caused by the breach."[101] The key issue here is whether the clause needs to be reasonable as to one or both of the guideposts. Does the clause have to be both a reasonable ex ante estimation and reasonable when compared ex post to actual damages? Second, it states that the reasonableness determination is to be judged based upon the "difficulties of proof."[102] A key issue is whether difficulty of proof is to be judged at the time of formation or at a latter time such as at the time of breach or at the time of trial. The use of the language *difficulty of proof* indicates that it is to be determined at trial. In short, the damages envisioned in the event of breach are those that are usually difficult to prove at trial. The difficulty of proof provision of Section 2-718 seems to contradict the reasonable estimation requirement. The fact that damages are generally provable at the time of trial would make it difficult to argue that the liquidated damages clause was utilized to avoid the difficulty of proving a loss. However, the more difficult it is to estimate the damages in question, the more likely it is that the clause will be seen as a reasonable estimate.

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proving that loss has occurred or of establishing its amount with the requisite certainty, the easier it is to show that the amount fixed is reasonable." *Id.* at 828.

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

U.C.C. § 718 (1) (1977). *See generally* Harwood, *supra* note 7.

[101] U.C.C. § 718 (1) (1977).

[102] *Id.*

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Section 2-718 provides a third element in judging the enforceability of liquidated damages clauses. The reasonableness of the clause should also be judged on the "inconvenience or nonfeasibility of otherwise obtaining an adequate remedy."[103] Again, it is unclear at what time this factor is to be weighed. At the time of formation, do the parties believe that the law does not provide an adequate remedy or that it would not be feasible to obtain a remedy provided under the law? Or, is feasibility or convenience to be judged at the time of breach or trial? In reality, courts often will ignore the third element. For example, in applying Section 2-718, the court in *Phillips v. Phillips*[104] stated a two-part test. "In order to enforce a liquidated damages clause, the court must find: (1) that the harm caused by the breach is incapable or difficult of estimation, and (2) that the amount of liquidated damages called for is a reasonable forecast of just compensation."[105] Besides disregarding the third prong, it is also unclear in this statement if the reasonableness determination is simply an ex ante estimate of anticipated loss or whether a discrepancy between actual loss and the stipulated amount is sufficient to void a clause. Ultimately, the court focused upon the fact that the stipulated amount was ten times that of the actual damages in voiding the clause as a penalty.

The confused and varied approach of the different prongs is evident in *Grumman Flexible Corp. v. City of Long Beach*.[106] The court first paid homage to the traditional common law's intentions approach before focusing upon the reasonableness rationale:

> In determining whether a liquidated damage provision is reasonable, the reviewing court must consider whether the contested clause is intended by the parties to operate in lieu of performance; if this is the case, the provision is enforceable. The Court also should examine whether the liquidated damage clause embodies a good faith effort to pre-estimate damages and whether it is based on the principle of just compensation.[107]

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[103] U.C.C. § 718(1) (1977).

[104] 820 S.W.2d 785 (Tex. 1991).

[105] *Id.* at 788 (quoting Stewart v. Basey, 245 S.W.2d 484 (Tex. 1952)).

[106] 505 F. Supp. 623 (S.D.N.Y. 1980).

[107] *Id.* at 626; *see also* Brecher v. Laikin, 430 F. Supp. 103 (S.D.N.Y. 1977) (in lieu of performance standard); Equitable Lumber Corp. v. IPA Land Dev. Corp., 344 N.E.2d 391 (1976) (good faith estimate principle); Nu-Dimensions Figure Salons v. Becerra, 340 N.Y.S.2d 268 (Sup. Ct. Queens 1973) (just compensation principle).

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The court stated that enforceability of the clause is to be determined based upon the intentions of the parties. It then stated that the parties' intentions must produce a clause that is a good faith pre-estimate of damages. A reasonable reading of this statement is that the clause itself need not be an accurate pre-estimate of damages, but only that the parties acted in good faith in its fabrication—that is that they believed it to be an accurate pre-estimate. The court then took a leap from the intentions approach to a two-pronged approach without any rational deduction. "*Thus*, two prerequisites must be satisfied. First, at the time the contract was entered into, the anticipated damages . . . must be incapable of, or very difficult of estimation. Second, the amount . . . must not be disproportionate to the damage reasonably anticipated for the breach as of the time the contract was made."[108] The court replaces the ex post notion of "difficulty of proof" or "nonfeasibility of obtaining an adequate remedy" in favor of *difficulty of estimation*, a seemingly ex ante calculation. The court also elected not to make a reasonableness determination by comparing the stipulated amount with the actual damages incurred. Instead, the court tapped into old case law, citing four cases dating from 1854 to 1910 to bolster its intentions and good faith estimate approach. The law of Connecticut further demonstrates this amalgamation of the common law and the Uniform Commercial Code approaches. The court in *Berger v. Shanahan*[109] described the tripartite test as constituting: (1) uncertainty or difficulty of proof, (2) reasonableness and not disproportionate to the amount of damage, *and* (3) intent of the parties to liquidated damages in advance.[110] This version of the three-part test leaves open the possibility that an otherwise reasonable stipulated amount may be unenforceable in the event that the parties did not exhibit the proper intention.

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[108] 505 F. Supp at 626 (citing Barnett v. Sayers, 289 F. 567 (1923); Cotheal v. Talmage, 9 N.Y. 551 (1854); Dunn v. Morganthau, 76 N.Y.S. 827 (1903); Mosler Safe Co. v. Maiden Lane Safe Deposit Co. 199 N.Y. 479, 93 N.E. 81 (1910)).

[109] 142 Conn. 726 (1995).

[110] *Id.* at 732.

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4. *The No Actual Injury Defense*

A number of courts have recognized the "no actual injury defense"[111] which voids a reasonable liquidated damages clause as viewed from the perspective of anticipated damages.[112] Thus, a liquidated damages clause that satisfies the requirements of the common law and Section 2-718 can still be negated upon the finding that the non-breaching party suffered no actual losses. The court in *Wassenaar v. Panos*[113] aptly stated this divergence of the law of liquidated damages in theory (all reasonable estimates of liquidated damages will be enforced) and practice (reasonable estimates will not be enforced if there are no actual injuries):

> Although courts have frequently said that the reasonableness of the stipulated damages clause must be judged as of the time of contract formation ... and that the amount or the existence of actual loss at the time of breach or trial is irrelevant, except as evidence helpful in determining what was reasonable at the time of contracting . . . , the cases demonstrate that the facts available at trial significantly affect the courts' determination of the reasonableness of the stipulated damages clause. 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.[114]

The no actual injury defense allows an ex post voiding of a liquidated damages clause that was a reasonable estimate of anticipated damages. The breaching party is allowed the defense that the clause is unreasonable when compared to actual damages. Alternatively, the defense can be phrased simply as the failure of *anticipated* damages to materialize. In the language of common law excuse, the clause has been *frustrated* by a subsequent unexpected event.[115] The unexpected event is the failure of a breach to produce

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[111] *See, e.g.*, Lind Bldg. Corp. v. Pacific Bellevue Dev., 776 P.2d 977 (1989) and as discussed in Weisfield, *supra* note 7. English law does not recognize the no injury defense. *See, e.g.*, Frank Griffith & Peter Marsh, 3 SUPPLY MGMT. 40 (1998) ("Indeed, they can still recover the specified sum whether they have incurred any loss or not.").

[112] *See generally* Weisfield, *supra* note 7.

[113] 331 N.W. 2d 357 (Wis. 1983).

[114] *Id.*

[115] "Under the English common law, a party's performance could be excused if some unforeseen event occurred that frustrated the purposes of the contract." RICHARD SCHAFFER ET AL., INTERNATIONAL BUSINESS LAW AND ITS ENVIRONMENT 172 (4th ed. 1999).

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any damages. Borrowing from the language of Section 2-719, the remedy provided by the liquidated damages clause fails of its *essential purpose.*[116]

When there are no actual damages "courts [have often] used equitable principles to avoid enforcing a liquidated damages clause."[117] The rationale most often used to justify the voiding of a negotiated liquidated damages clause is that the awarding of such damages in the face of no actual damages results in an unjust enrichment of the non-breaching party.[118] Should the unjust enrichment rationale be a winning argument? Is risk allocation unjust enrichment? Earlier court decisions have upheld a liquidated damage award despite the lack of actual damages under the premise that the clause was an intentional allocation of risk.[119] Therefore, it is not for the courts to reallocate the risk because of an unanticipated non-occurrence.[120]

5. *Burden of Proof*

The confusing state of liquidated damages law becomes apparent when the issue of burden of proof is analyzed. Under a traditional common law analysis, the burden of proof regarding the enforceability of a liquidated damages clause rests squarely on the

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[116] This is a reversal of the ordinary use of the essential purpose principle. Section 2-719 authorizes the use of limitation of liability or limitation of remedy clauses to limit the liability of a breaching party. However, if the limitation is too overbearing then it is said to fail of essential purpose to provide a minimal adequate remedy for breach. In that event, the clause is voided and the suing party can claim full expectancy damages. The use of the essential purpose principle in relationship to a liquidated damages clause would protect the breaching party from having to pay the stipulated amount in a situation in which there were no actual damages.

[117] Susan V. Ferris, *Liquidated Damages Recovery Under the Restatement (Second) of Contracts*, 67 CORNELL L. REV. 862, 866 (1982).

[118] *See, e.g.*, Massman Constr. Co. v. City Council of Greenville, 147 F.2d 925 (5th Cir. 1945).

[119] *See, e.g.*, United States v. Bethlehem Steel Co., 205 U.S. 105 (1907); Southwest Eng'g Co. v. United States, 341 F.2d 998 (5th Cir. 1965); McCarthy v. Tally, 297 P.2d 981 (Cal. 1956).

[120] *See, e.g.*, Rex Trailer v. United States, 350 U.S. 148 (1956); McCarthy v. Tally, 297 P.2d 981 (Cal. 1956).

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party seeking to set it aside.[121] The principle of freedom of contract dictates that express contract clauses are presumed to be enforceable.[122] Therefore, it is up to the challenging party to prove that a stipulated sum acts as a penalty.[123] The Ninth Circuit, applying California law, stated this generally accepted premise in the 1997 case of *Trust Company for USL v. Wien Air Alaska, Inc.*[124] The court held that "liquidated damages clauses are valid unless the party seeking to invalidate the provision establishes that the provision was unreasonable under the circumstances existing at the time the contract was made."[125] The court noted that a Comment to Section 1671 of the California Civil Code listed a number of factors to be considered in the reasonableness determination. It then held that the presence of one of the factors (lack of independent counsel) and the allegation of another (inequality of bargaining power) were insufficient to make the reasonableness of the liquidated damages clause an issue for trial. The Circuit Court upheld the lower court's summary judgment by asserting that the simple existence of such factors is not, by itself, "significant probative evidence."[126]

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[121] Generally, parties are held to the express terms of their contract. The burden or proof is on the person seeking to invalidate an express term in a contract. Professor Atiyah alludes to this when he states that "it sometimes seems almost as if public policy is invoked merely to overcome the general common law rule prohibiting the courts from interfering [in enforcing a contract term] on grounds of fairness." P.S. ATIYAH, THE LAW OF CONTRACT 316 (4th ed. 1989).

[122] The court in *Brecher v. Larkin* explained the aberrational nature of courts not enforcing express liquidated damages clauses. "While the freedom of parties to structure their agreement is universally acknowledged to be at the heart of the law of contract, the limited enforcement of clauses where parties have agreed to specified measures of damages is a judicial check on the freedom of contract . . . ." 430 F. Supp. 103, 106 (S.D.N.Y. 1977).

[123] English common law holds that "it is the party who is sued for the specified sum who has to prove that it is a penalty." ICC GUIDE, *supra* note 74, at 44.

[124] No. 96-15222, 1997 U.S. App. LEXIS 11958 (9th Cir. Mar. 12, 1997); *see also* Commercial Union Ins. v. La Villa Sch. D., 779 S.W.2d 102 (Tex App. 1989).

[125] 1997 U.S. App LEXIS 11958, at *9 (quoting Section 1671 of the California Civil Code).

[126] The court concluded that the challenging party had "not met its burden of presenting *significant probative evidence* that the liquidated damages provisions are unreasonable." *Id.* at 12 (emphasis in original).

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In contrast, compare a North Carolina District Court's decision in the 1998 case of *Brickwood Contractors, Inc. v. City of Durham.*[127] This case involved the enforceability of a liquidated damages clause in a contract for the repair and repainting of a city water tank. The liquidated damages clause provided for $700 per day in stipulated damages until "substantial completion" and $300 per day following substantial completion until "final acceptance." Based upon this clause the amount of recovery would be $502,600 on a contract price of $563,030. The liquidated damages clause stated that it was intended to provide for liquidated damages and not act as a penalty. The clause further stated that the parties recognized the "difficulty in proving or contesting the amounts of losses."[128] In its decision, the court stated that the law of North Carolina is that liquidated damages clauses should be enforced under certain conditions. The conditions of enforceability are "when damages are speculative or difficult to ascertain and the amount stipulated is a reasonable estimate of probable damages, or the amount stipulated is reasonably proportionate to the damages actually caused by the breach."[129] Since liquidated damages clauses are generally recognizable, then the burden to prove that the clause was unreasonable should be on the party challenging its enforceability. Instead, the court placed the burden upon the City of Durham. "[T]he burden is on the City to show that the liquidated damage amount was a reasonable estimate [at the time of contracting] of the probable damages the City would suffer should the contractor cause delay beyond the expected completion date."[130] It held for the contractor due to the city's failure to meet its burden of proof as to reasonableness.

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[127] No. 1:96CV00768, 1998 U.S. Dist. LEXIS 17339 (Mid. Dist N.C. Aug. 8, 1998); *see also* Brecher v. Laikin, 430 F. Supp. 103 (S.D.N.Y. 1977). "A party seeking to enforce a liquidated damages clause must meet two tests." 430 F. Supp. at 106.

[128] ICC GUIDE, *supra* note 74, at 25.

[129] *Id.* at 28 (citing Knutton v. Cofield, 160 S.E.2d 29 (1968); RESTATEMENT (SECOND) OF CONTRACTS § 356(1) (1981)); *see also* Ledbetter Bros. v. N.C. Dept. of Trans., 314 S.E.2d 761 (N.C. 1984).

[130] ICC GUIDE, *supra* note 74, at 32-33; *see also* Hanrahan v. Audubon Builders, Inc., 614 A.2d 748 (Pa. 1992) (non-breaching party required to provide evidence of the damages actually incurred).

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This juxtaposing of the burden of proof from the breaching party to the enforcing party is especially troubling.[131] Freedom of contract[132] dictates that the burden of proof rests upon the party challenging the enforcement of a contract clause. Thus, the burden should be on the breaching party to prove unreasonableness and not the aggrieved party to prove reasonableness. Although courts recognize this traditional allocation of the burden of proof, in reality the onus seems to be placed upon the non-breaching party to prove reasonableness. This is sometimes accomplished by lowering the threshold for proving unreasonableness and shifting the burden to the breaching party to rebut the evidence of unreasonableness. Generally, the case law evidences a judicial bias in marginal cases to classify clauses as penalties.[133] In fact, courts have generally recognized a presumption in favor of non-enforceability. The court in *Vernitron Corp. v. CF 48 Associates*[134] stated that "any reasonable doubt as to whether a provision constitutes an unenforceable penalty or a legitimate liquidated damages clause should be resolved in favor of the construction which holds the provision to be a penalty."[135] The standard burden of proof approach, where an express clause is presumed to be enforceable, would hold otherwise..

The "*or*" approach adopted under section 2-718 further confuses the issue of the burden of proof. One commentator notes that it provides two alternatives for the non-breaching party to prove reasonableness.[136] The first test is the traditional reasonableness

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[131] "The situation apparently contemplated by the Code drafters was that if a liquidated damages sum were to fail one alternative to section 2-718(1) it could still be redeemed by meeting reasonability under the alternative." ICC GUIDE, *supra* note 74, at 446.

[132] The numerous principles that underlie the common law's fundamental philosophical mantra of freedom of contract support the notion that contracts should be enforced as written. These principles include the adequacy of consideration doctrine, duty to read, and the parol evidence rule.

[133] *See, e.g.*, Raffel v. Medallion Kitchens of Minn., Inc., 139 F.3d 1142 (7th Cir. 1998). "Illinois courts resolve doubtful cases in favor of classification as a penalty." *Id.* at 1146; *see also* Lake River Corp. v. Carborundum Co. 769 F.2d 1284 (7th Cir. 1985).

[134] 478 N.Y.S.2d 933 (A.D. 1984).

[135] *Id.* at 934; *see also* Rattigan v. Commodore Int'l Ltd., 739 F. Supp. 167 (S.D.N.Y. 1990); Pyramid Centres & Co. v. Kinney Shoe, 663 N.Y.S.2d 711, 713 (A.D. 1997).

[136] The most widely accepted interpretation of section 2-718(1) requires that the stipulated amount be proportionate to *either* anticipated *or* actual harm. That interpretation preserves the 'look forward' test in the sense that a pre-agreed damages clause can meet that test and the clause will be upheld with-out reference to actual

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determination of anticipated damages made at the time of contract formation. The second alternative reflects the courts' previously covert consideration of disparity between actual damages and the sum stipulated in the clause. A common perspective on the disjunctive in Section 2-718 is that it allows the non-breaching party two avenues to prove the reasonableness of the liquidated damages clause.[137] If the aggrieved party can prove reasonableness of the clause at the time of formation or when compared to actual damages, then the clause is to be enforced. In fact, courts remain largely influenced by any disproportion between the stipulated amount and actual damages.[138] Some have ignored the reasonable estimate in favor of recognizing actual disparity at the time of breach or trial, while others have been swayed by knowledge of actual damages in their retrospective determination of the reasonableness of the anticipated damages.[139]

B. *Contracting Around the Law of Liquidated Damages*

Skilled contract drafters will generally avoid using the language of liquidated damages and penalty clauses. They cloak such provisions in neutral language such as a pre-agreed discount for performing or paying by a certain date. Generally, the use of neutral language to avoid the law of liquidated damages has failed. For example, a provision providing for an interest-based charge for late delivery has been held to be a liquidated damages clause in disguise.[140] A New York court held that an interest charge significantly divergent to market rates could be considered as an unenforceable penalty.[141] The

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harm. Conversely, a clause may be valid by reference to only the actual harm test. Note, *supra* note 8, at 1074.

[137] *Id.*

[138] "[T]he party against whom the stipulated sum is to be enforced would be likely to call the court's attention to actual damages in an attempt to discredit the court's finding of reasonableness at the anticipated damages time point." Case, *supra* note 7, at 447.

[139] *See, e.g.*, Wassenaar v. Panos, 331 N.W.2d 357, 362 (Wisc. 1983).

[140] "A liquidated damages clause can take many shapes. . . . [For example, a] delay in delivery of goods might be liquidated by multiplying the number of days of unexcused delay by a designated percentage of the selling price of the goods." Sweet, *supra* note 7, at 90.

[141] N. Bloom & Sons Ltd. v. Skelly, 673 F. Supp. 1260 (S.D.N.Y. 1987) (citing U.C.C. § 2-718(1) (1977)). Prepayment clauses in mortgage agreements have also been reviewed through the prism of liquidated damages law. *See generally* Dale A. Whitman, *Mortgage Prepayment Clauses: An Economic and Legal Analysis*, 40 UCLA L. REV. 851 (1993) "Essentially, prepayment fees are nothing more than liquidated damages clauses." *Id.* at 871; *see also* Coopersmith, *supra* note 7.

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clause at issue provided for a twenty-four percent per annum charge while the current market rate was approximately thirteen percent. The court held that the finance charge was not "a good-faith attempt to pre-estimate damages, this charge served as a penalty."[142]

A federal bankruptcy court in *In Re A.J. Lane & Co.*[143] held that a prepayment charge in a loan transaction could also be measured under the law of liquidated damages. It held that the "prepayment charge . . . is a natural result of treating prepayment as a breach . . . . When so considered, it is clear that the charge is a liquidated damage provision inserted to compensate the lender for the breach of early payment."[144] The court voided the one percent pre-payment provision by classifying it as a penalty.[145] It further noted that such a finding is appropriate even where "the transaction is fully voluntary and the parties have equal bargaining power."[146]

Another device used by contract drafters to avoid a judicial finding that a clause is a penalty is to provide for a series of amounts to be granted depending on the type or severity of the breach. Courts especially disdain liquidated damages provisions that give a lump sum regardless of the type or severity of the breach. Judge Posner articulated this issue in *Lake River Corp. v. Carborundum Co.*:

> When a contract specifies a single sum in damages for any and all breaches even though it is apparent that all are not of the same gravity, the specification is not the *reasonable effort to estimate* damages; and when in addition the fixed sum greatly exceeds the actual damages likely to be inflicted by a minor breach, its character as a penalty becomes unmistakable.[147]

The "reasonable effort to estimate" language can be interpreted as saying that a liquidated damages clause that is not a dickered term or a basis of the bargain will be subject to greater scrutiny than one

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[142] 673 F. Supp. at 1268. It should be noted that the court applied the law of liquidated damages after it determined that the usury laws were not applicable. It reasoned that the transaction was a sale of goods on credit and not a loan. *Id.*

[143] 113 B.R. 821 (D. Mass. 1990).

[144] *Id.* at 827.

[145] The clause in the note stated that "The BORROWER shall have the right to prepay . . . provided that the BORROWER shall pay a pre-payment penalty equal to the amount so prepaid times One Percent times the number of years." *Id.* at 822.

[146] *Id.* at 828 (citing Goetz & Scott, *supra* note 8, at 588-93).

[147] 769 F.2d 1284 (7th Cir. 1985) (emphasis added).

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provided in a contract or standard form of one of the parties. More generically, breaches come in a variety of forms such as non-performance, delayed performance, defective performance, and violations of ancillary duties such as a duty not-to-compete or not to disclose confidential information. Thus, the amount stipulated in a liquidated damages clause may be appropriate in the case of a material breach but would be considered a penalty if applied to a minor breach.[148] In 1998, a Federal District Court voided a liquidated damages clause stating that the "clause was not carefully drafted to tailor the amount of the award [to the different types of breaches]."[149] In that case the focus was not so much on the type of breach but rather the type of damages. The liquidated damages clause provided for a fixed per diem amount regardless of whether the item was sufficiently repaired enough to be placed into use. Failing to provide a recognition for "substantial performance" rendered it "over-broad and to operate as a penalty."[150] A graduated liquidated damages clause may show that the parties' intended purpose was to estimate the different types of damages that could arise from different types of breaches.[151] Such a gradation is also evidence that the clause was expressly negotiated and thus more likely to be an attempt to reasonably estimate.

Some courts have taken the approach of attacking clauses that treat minor and material breaches the same to an extreme, and found that a provision is unenforceable even if it is not a penalty for the particular breach that is at issue in the case.

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[148] At least one court simply held that such a clause would only pertain to material breaches. "[I]f a liquidated damages clause is general in a contract with several clauses of varying importance, the clause will be held applicable only to material breaches." Hackenheimer v. Kurtzmann, 138 N.E. 735 (1923), *cited in* Brecher v. Laikin, 430 F. Supp. 103, 106 (1977).

[149] Brickwood Contractors, Inc. v. City of Durham, No. 1:96CV00768, 1998 U.S. Dist. LEXIS 17339, at *37 (Mid. Dist N.C. Aug. 8, 1998); *cf.* Rowland Constr. Co. v. Beall Pipe & Tank Corp., 540 P.2d 912 (Wash. App. 1975) (a per diem rate was considered to be a penalty because it provided the same rate after the pipeline was placed in operation as before it was placed in operation); Horn v. Poindexter, 97 S.E. 653 (1918) (clause voided for not being narrowly tailored).

[150] *Id.*

[151] One commentator concluded that "a clause should regulate the stipulated amount or formula so that the forecasted damages will be commensurate with the gravity of expected actual harm." Weisfeld, *supra* note 7, at 982.

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> Where the contract containing the liquidated damages clause for its breach contains numerous covenants of varying degrees of importance, if the loss which might be anticipated as resulting from a breach of even the least of them is disproportionate to the amount of the liquidated damages, or if the loss which might result from a breach of any one of the covenants is readily ascertainable, then the clause will be held to be a penalty and unenforceable.[152]

This type of statement seems counter-intuitive. It is bizarre that a court would not focus on the particular breach at issue when assessing the reasonableness of the clause. If the stipulated sum is a reasonable estimate of damages for the particular breach, then its enforcement would be fair and efficient. The one argument that could be offered in defense of such an approach is that reasonableness is to be determined at the time of contracting. Therefore, since the parties cannot predict the type of breach that may transpire, the clause is a penalty ex ante. This is an inappropriate justification for such a draconian canceling of the clause given the use of actual damages as an alternative guide to reasonableness. If the courts are allowed to undertake an ex post review of the relationship between the stipulated sum and actual damages, then it should take into consideration the actual breach and damages in determining the reasonability of the stipulated sum in a unitary liquidated damages clause. This was recognized in a more recent case in which a District Court rejected the notion of *hypothetical breach*. The fact that one can "conjure a hypothetical breach that would produce miniscule actual damages does not undermine the validity of the clause."[153] This analysis stems from the perspective of actual breach and not some hypothetical breach transplanted retrospectively to the time of contracting. The court gave the following reason for its position: "To hold otherwise would essentially require contracting parties to bear the negotiating costs of tailoring liquidated damages provisions to calibrate damages differently depending on the various actual losses."[154] It concluded that "[t]his would largely defeat the central purpose that such provisions serve."[155] In short, it used general economic theory's

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[152] Vernitron Corp v. CF 48 Assocs., 478 N.Y.S.2d 933, 934 (N.Y. App. Div. 1984).

[153] DAR & Assocs. v. Uniforce Services, Inc., No. 98-CV-409, 1999 U.S. Dist. LEXIS 403, at *30 (E.D. N.Y. 1999).

[154] *Id.*

[155] *Id.*

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notion of transaction costs to reject the hypothetical breach approach in favor of actual breach.[156]

The courts' treatment of clauses that lack gradation is further evidence of the confusion inherent in the law of liquidated damages. As shown above, courts will use the fact that a clause lacks gradation as evidence that the clause was not a product of a reasonable estimate of anticipated damages. However, other courts have used the lack of gradation to satisfy the difficulty of proof prong. The fact that the parties knew that damages could vary and yet did not provide a gradated clause may be evidence that damages are of a type that are incapable or difficult of accurate estimation.[157] In short, if actual damages are difficult to prove or foresee, then a lack of gradation in the clause is justified. Thus, lack of gradation supports enforcement under the difficulty of proof prong and, at the same time, may support non-enforcement under the reasonable estimate prong.

Another typical liquidated damages technique is to base the damages upon a percentage of the contract price. The following clause was incorporated into a real estate sale contract custom drafted by a seller's attorney:

> Upon Purchaser's failure to take title, Seller shall be entitled to liquidated damages in the amount of ten percent of the purchase price for its damages not including the cost of 'extras.' The Purchaser's deposit shall be applied against the amount of the liquidated damages. The figure of ten percent of the purchase price for liquidated damages has been agreed upon between Purchaser and Seller because both parties agree that actual damages will be difficult to prove or arrive at accurately, since most of Seller's damage will be due to additional carrying costs on the Unit past the closing date (such as construction loan interest, taxes, overhead, etc.) to a date of closing a resale, which cannot be predicted, and may include additional factors such as difficulty in reselling the Unit at the same price.[158]

The drafting attorney pays homage to the dictates of liquidated damages law in order to enhance the likelihood of enforceability. The clause asserts that it is an appropriate response to the uncertainty of damages: "parties agree that actual damages will be difficult to

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[156] The idea of transaction costs will be more fully developed *infra* Section IV.C.

[157] Grumman Flexible Corp. v. City of Long Beach, 505 F. Supp. 623, 626 (1980) (citing Equitable Lumber Corp. v. IPA Land Development Corp., 381 N.Y.S.2d 459, 464 (1976)).

[158] Clause 15(c) of Unit Purchase Agreement (undated, on file with author).

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prove or arrive at accurately." It further states that such damages "cannot be predicted." The Second Circuit, in applying New York law, recently upheld a ten percent liquidated damages clause in a contract for the sale of a pool of mortgages.[159] Despite the plaintiff's ability to re-sell the mortgages, the court held that the clause was "not unreasonably disproportionate." It reasoned that the seller had a contractual expectation of earning a ten percent gain on the sale of the mortgages. "The fact that the [seller] was able to close on some but not all of the mortgages [was] irrelevant since the [seller had] a right to repudiate the entire contract."[160]

In drafting a liquidated damages clause, special concern should be used to understand its relationship to other provisions in the contract or in the law.[161] The way breach is defined within the contract will be crucial to determine if the liquidated damages clause has been legally triggered. Equally important is how the contract defines materiality of breach as it pertains to the liquidated damages clause. Failure to deal with the issue of materiality will likely render the liquidated damages clause unenforceable. Also, the liquidated damages clause should be analyzed in relation to the contractual *force majeure* clause and the law of excuse. If the contract or the law excuses a party for a breach caused by an external event, does that event also void the operation of the liquidated damages clause?

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[159] 3H Enter., Inc. v. John Murray, No. 98-7287, 1998 U.S. App. Lexis 28281, at *6 (2d Cir. Nov. 6, 1998) (citing Time Associates, Inc. v. Blake Realty, Inc., 622 N.Y.S.2d 816 (1995); Truck Rent-A-Center, Inc. v. Puritan Farms 2d, Inc, 393 N.Y.S.2d 365 (1977)).

[160] *Id.*

[161] "All provisions in a contract are considered and construed together and in harmony with each other." Metropolitan Life Ins. Co. v. Strand, 255 Kan. 657, 671; 876 P.2d 1362 (1994); *see also* TMG Life Ins. Co. v. Ashner, 21 Kan. 234, 249; 898 P.2d 1145 (1995). In some instances, the liquidated damages clause may have to be interrelated to similar clauses in other contracts. This is commonly the case where performance of one contract is dependent on performance of another contract. An example can be found in construction contracts where there is a prime contract (owner-general contractor) and a subcontract (general contractor-subcontractor). Courts have held that the purpose of the liquidated damages clause in the subcontract is to reimburse the general contractor for payments made under a similar clause in the prime contract. Thus, any otherwise reasonable liquidated damages clause in the subcontract is not enforceable when the general contractor is not assessed liquidated damages under the prime contract. *See, e.g.*, United Tunneling Enterprises, Inc. v. Havens Constr. Co, Inc., No. 96-4061-SAC, 1998 U.S. Dist. LEXIS 21236 (D.Kan. 1998); Industrial Indemnity Co. v. Wick Construction Co., 680 P.2d 1100 (Alaska 1984).

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A motivated court may avoid the law of liquidated damages simply by construing a clause neither as one for liquidated damages or as a penalty clause. This was the technique used by a Federal District Court in *Blanchard & Company, Inc. v. Heritage Capital Corp.*[162] In that case a "Supplier Agreement" contained a provision that required the purchaser to purchase a minimum quantity of items from the supplier. In the event that it failed to purchase the agreed upon amount, the contract provided for the payment of a fixed percentage of the purchase price in damages. The court held that a failure to make a minimum purchase did not constitute a breach of the contract. Therefore, it held that the stipulated amount was not compensation for an injury caused by a breach and as such was not a liquidated damages clause. "A provision for payment of a specified sum as compensation for acts contemplated by the contract, as opposed to compensation for injury resulting from breach of contract, is neither a penalty nor liquidated damages."[163] These provisions are generally known as "alternative performance clauses." However, courts will scrutinize these clauses and void them if they determine that they are disguised penalties.[164]

A clause that has arbitrarily been reviewed under the rubric of liquidated damages law is the attorney fees clause.[165] In *Korea First Bank v. Lee*[166] the losing party challenged a provision that required the payment of an additional fifteen percent of the judgment amount to provide for attorneys' fees. The District Court placed the burden of proof regarding the issue of reasonableness on the party claiming

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[162] No. 3:97-CV-0690-H, 1998 U.S. Dist. LEXIS 13768 (N.D. Tex. 1998).

[163] *Id.* at *10-11 (quoting 22 AM. JUR. 2d *Damages* § 213 (1965)); *see also* Kirby v. United States, 260 U.S. 423, 427 (1922).

[164] Comment c of Section 356 of the Restatement (Second) of Contracts deals with the issue of alternative performance clauses as disguised penalties. It states:

> Sometimes parties attempt to disguise a provision for a penalty by using language that purports to make payment of the amount an alternative performance under the contract, that purports to offer a discount for prompt performance, or that purports to place a valuation on property to be delivered. Although the parties may in good faith contract for alternative performances and fix discounts or valuations, a court will look to the substance of the agreement to determine whether this is the case or whether the parties have attempted to disguise a provision for a penalty that is unenforceable.

RESTATEMENT (SECOND) OF CONTRACTS § 356 comm. c (1981).

[165] *See, e.g.*, McIntire v. Cogly, 37 Iowa 676 (1873).

[166] 14 F. Supp. 2d 530 (S.D.N.Y. 1998).

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relief under the clause. It ordered that any subsequent award for attorney fees should only be granted after a full disclosure of the claiming party's actual fee arrangement and a finding of reasonableness.[167] Thus, the normal burden of proof allocation is reversed since the burden of reasonableness is placed upon the party seeking to enforce an express attorney fee clause.

This review of the current and past law of liquidated damages demonstrates a need to develop more coherent and uniform standards in order to enforce otherwise fair liquidated damages clauses—especially those which are the product of negotiation and consent. Part IV will attempt to provide further justification, through the perspective of efficiency, for the reformulation of the law of liquidated damages. It will argue that efficiency supports a presumption in favor of the enforcement of so-called penalty clauses.

IV. UNDERSTANDING THE LAW OF LIQUIDATED DAMAGES FROM AN EFFICIENCY PERSPECTIVE

Professor Kornhauser once admonished that "[t]hose seeking to reform the law of liquidated damages ... would do well to consult the economically informed literature."[168] The following coverage of the law and economics literature in the area of liquidated damages is divided into three sub-sections. The first sub-section summarizes the economic arguments used to support the non-enforcement of penalty clauses. The second sub-section reviews the efficiency arguments in favor of the enforcement of such clauses. The final sub-section suggests that an alternative perspective may be appropriate. Instead of viewing all penalty clauses as either efficient or inefficient, a better approach is to recognize that some penalty clauses may indeed be efficient, while others are inefficient. A theory of efficient penalty recognizes the efficiency of many penalty clauses. That said, it may be beyond the ability of the law to differentiate efficient and

[167] Any motion for attorney fees under the attorney fees clause "shall disclose the actual fee arrangement between plaintiff and its counsel and address the issue of reasonableness." 14 F. Supp. 2d 530, 533 (S.D.N.Y. 1998).

[168] Kornhauser, *supra* note 8, at 684-85. The precursor to the development of efficient breach theory can be traced to Oliver Wendel Holmes. Before the turn of the twentieth century Holmes asserted that "[t]he duty to keep a contract at common law means a prediction that you must pay damages if you do not keep it, and nothing else." Oliver Wendel Holmes, *The Path of the Law*, 10 HARV. L. REV. 457, 458 (1897).

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inefficient penalties. Nonetheless, the recognition of efficient penalties requires that the law provide a stronger presumption in favor of the enforceability of liquidated damages clauses.

A. *Efficient Breach Theory and Penalty Clauses*

The International Chamber of Commerce's *Guide to Penalty and Liquidated Damages Clauses* states that enforceable clauses generally must demonstrate a relationship between the amount to be paid and the performance due under the contract. It states that "[a] sum payable under a clause may sometimes be understood as an alternative for the obligor to perform the contract."[169] This type of statement invites an analysis of liquidated damages clauses through the prism of efficient breach theory.

1. *Inducing Inefficient Performance*

Efficient breach theory has been used to argue for the non-enforcement of penalty clauses. The argument is essentially the one introduced by Oliver Wendel Holmes that a contract only provides a prediction that one of the parties will pay damages upon breach and it is not a guarantee of performance.[170] The amount of damages to be paid under common law translates into the payment of compensatory or expectancy damages and nothing more. A liquidated damages clause becomes a penalty when the stipulated sum is greater than the compensatory damages collectable under the law. The penalty, thus, inflates the price of breach. In the range of the inflated price of breach the prospective breaching party is compelled to continue its performance. From the perspective of compensatory damages, this performance is inefficient because it is above the price of efficient breach.[171]

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[169] ICC GUIDE, *supra* note 74, at 19.

[170] In 1897 Holmes wrote that "[t]he duty to keep a contract at common law means a prediction that you must pay damages if you do not keep it, and nothing else." Holmes, *supra* note 168, at 458.

[171] *See, e.g.*, Cavico, *supra* note 56, at 371 ("[L]iability beyond [expectancy] would extinguish the economic incentive to pursue more profitable venture, thereby inhibiting breaches of inefficient agreements, breaches which arguably should not be discouraged, but urged.").

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The inducement of inefficient performance argument is haphazardly fused with a *windfall* argument in *Leasing Serv. Corp. v. Justice & Childers*:[172]

> The rationale for the principle [against penalty clauses] is that contractual terms fixing damages in an amount clearly disproportionate to actual loss seek to deter breach through compulsion and have an *in terrorem* effect: fearing severe economic loss, the promisor is compelled to continue performance, while the promisee may reap a windfall in excess of his just compensation.[173]

However, the fact that the promisee obtains a windfall is not necessarily bad or inefficient. A windfall would only be generated if the promisor elected to breach and pays the penalty. The promisor would only elect to do so if the breach opportunity provided a sufficient surplus. In that event, the promisee's windfall would simply represent a sharing of the promisor's surplus. The breach and payment of the penalty would enhance the utilities of both parties.

Professors Clarkson, Miller, and Muris[174] argued that the rule against penalties is necessary to prevent inducement of breach by the non-breaching party. Their basic argument is that a supracompensatory liquidated damages clause will provide an incentive for the non-performing party to induce a breach. In response, the performing party will attempt to counter the non-performing party's opportunistic behavior. Additional costs will be expanded to detect the other party's opportunistic inducement and to prevent breach.[175] One inherent flaw in their argument is that the non-performing party must not only have an incentive but also the opportunity to induce breach. The authors do acknowledge that non-enforcement does hinge on the finding of both incentive and opportunity.[176] Their assumption is that the cases where the non-performing would lack such opportunity are relatively small. I am not so sure this is the case. In realty, true opportunity without the likelihood of detection seems more likely to be a rarity especially in

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[172] 673 F.2d 70 (2d Cir. 1982).

[173] *Id.* at 73.

[174] Clarkson et al., *supra* note 8.

[175] "Resources spent both on breach-inducing activities and on detecting and preventing breach inducement are wasteful." *Id.* at 370.

[176] *Id.* at 378-90.

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commercial transactions where fungibility and transparency are the norms. Given the fact that the implied duties of good faith and fair dealing are so entrenched in modern day contract law, such bad faith inducement would cause a voiding of the clause, along with making the inducing party liable for full breach of contract damages and potentially punitive damages. Unless a low probability of detection ex ante by the performing party or ex post by a court can be verified, the "non-enforcement to prevent inducement rationale" loses vitality.

Professor Muris recognizes in a subsequent article that there is an implied condition that penalty clauses will not be enforced in cases of inducement. "[C]ourts will police enforcement of the clauses against possible opportunistic behavior."[177] He argues that the penalty rule efficiently serves the policing function by eliminating clauses that create both incentive and opportunity. If penalty clauses serve other functions, however, then general enforcement would still be a preferred rule.[178] Instead of carving out an exception to enforcement, opportunistic inducement can be controlled by the general limiting doctrines of good faith, fair dealing, unconscionability, and fraud. It should also be noted that the parties are in the best position to deal with the threat of opportunistic inducement. They may negotiate provisions recognizing events that preempt the operation of the liquidated damages clause. The need to contractually deal with such opportunistic inducement has been recognized in some of the trade literature. For example, one commentator argues that it is time for a new approach to writing liquidated damages clauses. The *new* liquidated damages clauses would provide "credits to reflect days when the contractor is prevented from working by certain defined events. The emphasis would be on the extent to which the contractor is prevented from working rather than the extent to which the contractor is delayed."[179] One such defined event are delays caused by the other party

Another argument can be devised using Goetz and Scott's notion of *precaution costs*.[180] One could argue that penalty clauses provide

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[177] Muris, *supra* note 8, at 581.

[178] The other functions that penalty clauses serve will be developed in sub-section B.

[179] Philip Davenport, *Extensions of Time – Time for Change*, 11 CONSTRUCTION MGMT. & ECON. 305 (1993).

[180] *See generally* Charles Goetz & Robert Scott, *Enforcing Promises: An Examination of the Basis of Contract*, 89 YALE L.J. 1216 (1980).

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incentive to the performing party to take undue precaution in order to avoid the triggering of the penalty. It is the function of contract remedies to minimize transaction costs such as precaution expenditures. Expectancy damages can be seen as offering the proper remedial incentive by attempting to minimize the risk of undue precaution (by the performing party) and excessive reliance (by the non-performing party). However, an argument can be made that the non-enforcement of penalty clauses may, in fact, lead to a risk-averse party incurring sub-optimal self-precaution costs against the contingency of breach.[181] A more cost-effective means of minimizing self-precaution costs is for the performing party to provide insurance against such a contingency through a penalty clause. It is the performing party that is in the best position to determine the probability of breach and to minimize that probability.[182]

2. *The Externalities of Enforcement*

Some economists have offered efficiency arguments, based upon the existence of externalities, for the non-enforcement of penalty clauses. Professor Rubin argues that although such clauses may be efficient from a two-party analysis, penalty clauses produce externalities that render them inefficient. "[W]hile penalty clauses are efficient vis-à-vis the two parties involved, their effects on third parties serve to make them, net, inefficient."[183] Rubin argues that penalty clauses increase the likelihood of litigation since the party benefiting from such a clause has the incentive to prevent the performing party from performing fully. The externality stems from the fact that society subsidizes litigation. Thus, the parties are not required to internalize the full costs of litigation creating an inefficient use of resources. The subsidy can be justified because litigation produces societal benefits by creating rules and precedents that can

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[181] This material was gleaned from MICHAEL J. TREBILCOCK, THE LIMITS OF FREEDOM OF CONTRACT 167 (1993).

[182] A real world example of this can be found in the trade literature. *See, e.g.*, *Expensive Concrete Saves on Liquidated Damages*, ENGINEERING NEWS RECORD, Sept. 19, 1994, at 33 ("Contractors reconstructing the aging runways at Seattle-Tacoma International Airport face $3,130 a day in liquidated damages for late completion. To complete the 12-year reconstruction under harsh constraints, contractors are using an expensive rapid-set concrete.").

[183] Rubin, *supra* note 8, at 243.

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be used by other private parties in the future. However, Rubin argues that litigation over the enforcement of penalty clauses fails to produce such rule efficiency. "In litigation about penalty clauses, no rules are promulgated."[184] Secondly, he argues that penalty clauses breed litigation mainly because of the benefiting party's incentive to induce a breach by the performing party.[185] I would argue against both of these points. A default rule that enforces penalty clauses would preclude litigation as an option for the breaching party. As such, the efficiency savings from the enforcement of clauses negotiated ex ante would include the costs of the litigation, including parties' litigation costs and the cost of the public subsidy. Also, litigation over penalty clauses are just as likely to establish rules, precedents, and guideposts pertaining to the likelihood of success in enforcing such provisions. Additionally, the non-enforcement of penalty clauses has not stymied the steady stream of litigation. The law of liquidated damages has generated continuous litigation even when the clauses are reasonable ex ante estimates of damages.[186] The breaching party is provided an incentive to contest freely negotiated clauses due to the judicial bias against their enforcement.

Professor Rubin also makes a systemic argument in favor of the efficiency of not enforcing penalty clauses. The general view is that the common law mimics the free market system. Inefficient rules are evolved out of the system.[187] The persistence of the penalty and forfeiture rules indicates that the rules are per se efficient. "The long-term persistence of this clause and the lack of paternalism in other areas of contract law thus create at least a prima facie case that there is some economic-efficiency basis for the behavior of the courts."[188] One needs only look to the persistence of other archaic rules for the

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[184] *Id.* at 244.

[185] This was the main argument made by Clarkson, Miller, and Muris in their 1978 article. Clarkson et al., *supra* note 8.

[186] This was noted in Professor Rea's critique of Rubin's arguments. "[T]he additional uncertainty associated with the unenforceability of penalties might increase litigation." Rea, *supra* note 8, at 149.

[187] *See* George L. Priest, *The Common Law Process and the Selection of Efficient Rules*, 6 J. LEGAL STUD. 862 (1982); Paul Rubin, *Why is the Common Law Efficient?*, 6 J. LEGAL STUD. 51 (1977).

[188] Rubin, *supra* note 8, at 243.

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fallacy of this argument.[189] For example, the statute of frauds remains in this country despite its repeal in the United Kingdom.[190] The weight of most academic analysis favors the elimination of the statute of frauds, at least in the area of sales of goods.[191] First, it does not perform the cautionary and deterrent functions given by Lon Fuller as the philosophical rationale for contractual formalities.[192] Second, the writing requirement, especially as interpreted in Article 2 of the Uniform Commercial Code, has been thoroughly weakened. The law's definition of writing has increasingly recognized greater informality and the existing exceptions[193] have been liberally construed. Persistence does not equate to either efficiency or perpetual invulnerability. The following sub-section attempts to provide some of the economic rationales in favor of repealing the rule against penalties.

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[189] The persistence of the infancy law doctrine belies the law's destruction of the rule through the constant development of exceptions. *See generally* Larry A. DiMatteo, *Deconstructing the Myth of the "Infancy Law Doctrine": From Incapacity to Accountability*, 21 OHIO N. U. L. REV. 481 (1994).

[190] White & Summers note that "the original rationale for the statute of frauds for goods faded. Yet the statute remained until 1954 in England and it is still much alive in the United States today." JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE § 2-1, at 41 (4th ed. 1995).

[191] *See, e.g.*, E. Allan Farnsworth, *Developments in Contract Law During the 1980's: The Top Ten*, 41 CASE W. RES. L. REV. 203 (1990) (the erosion of the role of formalities subsided during the 1980's); John P. Fischer, *Computers as Agents: A Proposed Approach to Revised U.C.C. Article 2*, 72 IND. L. J. 545 (1997) (reviews previous proposed revision of Article 2 that would have repealed the statute of frauds); Jason Scott Johnston, *The Statute of Frauds and Business Norms: A Testable Game-Theoretic Model*, 144 U. PA. L. REV. 1859, 1863 (1996) ("For over one hundred years, this statutory writing requirement has been criticized as fundamentally at odds with business norms and as having no effect on business behavior."); Jeffrey Kagan, *The Indelibility of Invisible Ink: A Critical Survey of the Enforcement of Oral Contracts Without the Statute of Frauds Under the U.C.C.*, 19 WHITTIER L. REV. 423 (1997); Evander Willis, *The Statute of Frauds—A Legal Anachronism*, 3 IND. L.J. 427 (1928) (shows that critiques of the statute of frauds is not a recent phenomenon); *see also* James J. O'Connell, Jr., Note, *Boats Against the Current: The Courts and the Statute of Frauds*, 47 EMORY L.J. 253 (1998); Robert A. Feldman, *Lightening the Load: Doing Away with a Writing Requirement*, 6 CORP. LEGAL TIMES 12 (1996).

[192] Lon L. Fuller, *Consideration and Form*, 41 COLUM. L. REV. 799 (1941).

[193] *See, e.g.*, Sections 1-201(39) (definition of "signed); 1-201(46) (definition of "writing"); 2-201 (written confirmation rule); 2-201(3)(a) (specially manufactured goods exception); 2-201(3)(b) (admission exception); 2-201(3)(c) (partially executed contracts exception); 2-209(3) (modification and waiver).

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B. *General Economic Theory: Arguments in Favor of Eliminating the Law of Liquidated Damages*

The uncertainty of the amount of damages that a future litigation may impose on one of the parties increases the risks of contracting. One way of lowering transaction costs or uncertainty is to allow the parties to agree to the amount of damages awarded for breach. A Coasian argument can be made that such pre-agreement reduces the transaction costs of contracting.[194] By bracketing the damages, the parties can limit the risks of entering into the contract. The perspective breaching party can calculate the risks of entering into the contract by factoring the probability of breach and the pre-set amount of damages to be awarded upon breach.[195] Also, the perspective non-breaching party can calculate the attractiveness of entering into the contract based upon the assured minimum amount of damages to be awarded.

The, at times, blurry distinction between liquidated damages and limitation of liability offers an opportunity for comparative analysis. The court in *Golden Reward Min. Co. v. Jervis B. Webb Co.*[196] held that a limitation of liability clause that excluded consequential damage recovery between commercial parties was not unconscionable as a matter of law. Its rationale was that such a clause was a "bargained for allocation of risk."[197] It argued that a judicial intervention to void such a clause was an unnecessary interference with a negotiated business transaction.

> Parties of relatively equal bargaining power negotiated an allocation of their risks of loss. Consequential damages were assigned to the buyer. The machine was a complex piece of equipment designed for the buyer's purposes. The seller did not ignore his obligation to repair, he simply was unable to perform it. This is not enough to require that the seller absorb losses the buyer plainly agreed to bear. *Risk shifting* is socially expensive

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[194] Ronald H. Coase, *The Problem of Social Cost*, 3 J. L. & ECON. 1 (1960).

[195] Professor Sweet states that the "performing party may wish to avoid the feared irrationality of the judicial process in determining actual damages." Sweet, *supra* note 7, at 86.

[196] 772 F. Supp. 1118 (S.D. 1991).

[197] *Id.* at 1124 (citing Milgard Tempering, Inc. v. Selas Corp. of America, 902 F.2d 703 (9th Cir. 1990); S. M. Wilson & Co. v. Smith Int'l, Inc., 587 F.2d 1363 (9th Cir. 1978)).

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> and *should not be undertaken* in the absence of a good reason. *An even better reason is required when to shift is contrary to a contract freely negotiated.*[198]

Extending this analysis to liquidated damages clauses, such clauses are risk allocation devices that are freely entered into by the parties. The risk of under or overliquidation is allocated to one of the parties. One party is assured of a minimum level of recovery; the other party is assured a maximum level of liability. In contracts between commercial entities, the courts should not tamper with such allocations.[199]

Economists have generally focused on the inefficiency of voiding bargained-for contractual terms.[200] The rationale forwarded is that the market, through contract law, internalizes all costs. Courts should refrain from intervening in the market's production of contracts. The non-enforcement of liquidated damage clauses is an affront to economic theory. Richard Posner has described the law of liquidated damages as a "major unexplained doctrine in the economic theory of the common law."[201] Under general economic theory, the courts' increased focus on actual damages is especially troublesome. Free bargaining is essentially a time of contract issue. The fact that some event, often unforeseen, results in an unexpected disparity between anticipated damages and actual damages should not warrant judicial intervention. In the overliquidated damages scenario the non-breaching party benefits from over-insurance retroactively construed. In the case of underliquidation, the non-breaching party suffers from

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[198] *Id.* (quoting Milgard Tempering, Inc., 902 F.2d at 708 (emphasis added)).

[199] The conclusion in the Golden Reward case is applicable to any contractual risk allocation.

> [The parties] are large commercial entities which negotiated for the purchase . . . at arms length. When the contract excluded recovery for consequential damages, both parties were aware of what this meant in the context of their agreement. The end result is no more or less oppressive than the parties perceived it to be. This Court will not interfere with what is simply a bargained-for allocation of risk.

Id. at 1125.

[200] "Economists generally believe that any voluntary contract between two parties is efficient." Rubin, *supra* note 8, at 241.

[201] Richard A. Posner, *Some Uses and Abuses of Economics in Law*, 46 U. CHI. L. REV. 281, 290 (1979).

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under insurance.[202] In both situations, as in the insurance world, the parties made an allocation of risk based upon expected damages. By implication, such an allocation includes the shifting of the risk of unexpected losses. The probability of such unexpected damages and the range of potential damages should be reflected in the premium paid by the non-breaching party through an adjustment of the contract price. The price adjustment due to perceived risk of unexpected damages will also be influenced by whether the parties are risk preferring, risk neutral, or risk averse. The importance of this analysis is that if liquidated damages clauses are viewed as risk allocation devices, then they should be strictly enforced as are other contract clauses that allocate risk.[203] In cases where the liquidated damages clauses were unreasonable *ex ante*, the courts should be required to see if there were any viable reasons for the parties to agree to a penalty clause. For example, a new firm or historically undependable party, may agree to a penalty clause in order to persuade a party to enter into a contract that they would not ordinarily enter.[204] If no viable reason exists, then analysis offered by the limiting principles of fraud, mistake, and unconscionability can be brought to bear.

1. *Efficiency in Contracting: The Cautionary Function*

The rationale for contractual formality given by Lon Fuller in his landmark law review article, *Consideration and Form*,[205] can be applied to the use of liquidated damages clauses. Such clauses serve to caution and deter parties from hastily committing to performance obligations. Professor Kornhauser states that if "the law of contract seeks to promote efficient conduct, ... then the rules should be selected that reveal to the decision maker the full consequences of her

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[202] The insurance rationale has also been used to justify the use of prepayment fees in mortgage contracts. "[T]he prepayment fee can be viewed as a form of insurance. The insurance *premium* is the prepayment fee itself. . . . In effect, the [prepayment] fee buys certainty for the borrower, and the lender is rewarded financially for absorbing the risk of market rate fluctuation." Whitman, *supra* note 141, at 873 (emphasis in original).

[203] The classic example is a custom negotiated *force majeure* clause. Generally, courts will recognize any risk allocation (excuse) expressly negotiated in a *force majeure* clause.

[204] RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 93 (2d ed. 1977). For arguments for the efficiency of penalty clauses, see Goetz & Scott, *supra* note 8.

[205] Fuller, *supra* note 192.

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decisions."[206] A party faced with a penalty provision is more likely to make a rational assessment of the feasibility of its performance obligations under the contract when involved in negotiations. The fear that parties do not appreciate ex ante the gravity of liquidated damage clauses is unfounded, especially in the commercial context. The gravity is likely to be appreciated by commercial contracting parties either directly or through their attorneys.[207] A court in rejecting an argument that a clause was "penal on its face" noted the importance of negotiation. The court reasoned that "if this is true, [why did they negotiate the clause], although they technically do not need to, since contract law forbids attempts to secure performance through penalties."[208] This appreciation shifts the emphasis of such clauses from mere boilerplate to heightened scrutiny. This scrutiny is likely to have a spillover effect on the rest of the contract. The performing party may attempt to negotiate a higher price, a longer time for performance or delivery, and a more expansive *force majeure* clause. The beneficiary party may be willing to compromise on those types of clauses in order to obtain a more favorable risk allocation represented by the liquidated damages clause.

An economic argument can also be developed around Kronman and Posner's assertion that "the law of contracts imposes costs on, and thereby discourages, careless behavior in the contracting process."[209] Negotiation of the liquidated damages clause by its nature alerts the parties to the seriousness of the undertaking. Also, the additional costs incurred in negotiating the clause add to the cautionary function served by contracting in the shadow of the law. Two assumptions are needed to further the argument for the cautionary function of liquidated damages clauses. First, the costs of dispute resolution or renegotiation are greater than the transaction costs involved in negotiating a liquidated damages clause. Second, if the clause is enforceable, then it will serve to discourage the litigation. Given these assumptions, negotiation and enforcement of the liquidated damages clause serves to reduce total transaction costs.

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[206] Kornhauser, *supra* note 8, at 724.

[207] This assertion is made based upon ten years of contract law practice.

[208] DAR & Assocs. v. Uniforce Services, Inc., No. 98-CV-409, 1999 U.S. Dist. LEXIS 403, at *26 (E.D. N.Y. 1999).

[209] ANTHONY T. KRONMAN & RICHARD A. POSNER, THE ECONOMICS OF CONTRACT LAW 4 (1979).

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2. *Efficiency in Contracting: Transaction Costs and the Internalization of Risk*

The inclusion of a liquidated damages clause can be seen as a technique to overcome informational shortcomings in the search and formation stage of contracting. A party agreeing to a liquidated damages clause provides the other party with another factor with which to compare potential contracting parties. Such clauses provide a greater certainty that would not generally be available when dealing with a stranger. In this sense the liquidated damages clause acts much like a warranty clause. However, the courts are more predisposed to enforce a generous warranty provision while they are predisposed to invalidate *generous* liquidated damages clauses. Another scenario where a clause becomes helpful occurs when a buyer has nothing to differentiate potential sellers. "If buyers cannot [otherwise] differentiate low risk from high risk sellers, a sellers' acceptance of a penalty clause is a signal of a low probability of breach."[210] The need to increase transactions costs in order to more fully investigate the other contracting party is diminished through the insurance value provided by the liquidated damages clause.[211] Also,

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[210] Rea, *supra* note 8, at 156. However, one can argue that a performing party willing to give up the limited liability default rule of actual damages may actually send an opposite signal. Professor Trebilcock states this idea of *negative signaling*, especially if the higher liability option is encouraged by the performing party: "Bargaining around limited liability [actual damages] put the [performing party] in a strategic dilemma: if he persuades [the other party] that he would be better off with the high-priced—high liability alternative [penalty], then he may also persuade the shipper that he is in fact better off not contracting with him at all because the breach probability is too high." TREBILCOCK, *supra* note 181, at 123-24. Professor Gergen has argued that rarely do parties actually intend a clause to be penal in nature. Moreover, he asserts that it is only in "a few cases that void liquidated damages clauses seem to involve genuine penalties." Mark P. Gergen, *A Defense of Judicial Reconstruction of Contracts*, 71 IND. L.J. 45, 49 (1995).

[211] "An insurance contract reduces the variation in wealth to which an individual is exposed. . . . Economists call this preference for certain, as opposed to uncertain, returns *risk aversion*. . . . [T]he degree of risk aversion which people exhibit may affect the choice of the most *efficient* contract remedy." Kornhauser, *supra* note 8, at 688 (emphasis in original). Alternatively, a liquidated damages clause *qua* penalty can be viewed as a form of *hostage* taking. Oliver Williamson has noted that opportunistic behavior can be reduced through a "credible commitment" such as the delivery of a hostage. *See* Oliver E. Williamson, *Credible Commitments: Using Hostages to Support Exchange*, 73 AM. ECON. REV. 519 (1983). Of course, this is antithetical to the notion of efficient breach. *See generally* Muris, *supra* note 8.

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the pool of credible contracting parties is widened beyond those with an existing business history or those with prior dealings.

The above argument can be re-stated as the use of liquidated damages clauses as a technique to overcome informational asymmetry. Information may be *commodified* through liquidated damages clauses. A shortage of information by one of the parties may be a preferred alternative to the costs of overcoming the shortage.[212] The recognized irrationality of proceeding to contract despite the informational asymmetry may be justified by shifting the risk of the asymmetry to the party with superior information. This may be done through the risk shifting function of a liquidated damages clause. The party contracting for the performance of another party may decide that the costs of investigating alternative performance options in case of breach are prohibitive. Thus, a decision to pay a premium in order to obtain a penalty clause may indeed be a rational choice.[213]

New entries into the market can overcome their competitive shortcomings by providing risk-averse parties a more advantageous risk allocation by way of a liquidated damages clause.[214]

The costs and risks of liquidated damages clauses can be seen as a pure cost of business. It is a cost that a party can internalize in order to generate more business and greater revenues. Professor Kornhauser asserts that penalty clauses can be the product of rational contract making:

> When the promisee demands a *penalty clause*, the promisor will agree only if the price is increased sufficiently to cover any increase in the cost of performance. ... [S]ince it seems plausible that commercial contractors

[212] Professor Slawson states the argument as follows: "[T]he reason must be that they [consumers] prefer choosing in ignorance to paying costs of obtaining the information they would need to choose intelligently . . ." SLAWSON, *supra* note 55, at 39.

[213] Professor Trebilcock states this premise succinctly: "[B]ecause information is often costly it may be rational to choose to forgo the acquisition of further information where the expected benefits are less than its expected costs." TREBILCOCK, *supra* note 181, at 103; *see also* George J. Stigler, *The Economics of Information*, 69 J. POL. ECON. 213 (1961).

[214] One commentator counters this rationale by arguing that the penalty rule is an example of a *restrictive contract doctrine* that acts as an "appropriate means for deterring socially costly behavior." In short, the penalty clause may be nothing more than a calculated gamble—the free market's production of "perverse incentives to take credit risks." Non-enforcement of such clauses is contract law's way of deterring such behavior. Eric A. Posner, *Contract Law in the Welfare State: A Defense of the Unconscionability Doctrine, Usury Laws, and Related Limitations on the Freedom to Contract*, 24 J. LEGAL STUD. 283, 285 (1995).

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> act largely in their *rational* self-interest, it is likely that both parties initially saw a benefit even in a clause which a court later terms a penalty. This benefit might simply be to trade a risk that one party perceives as high to a second party who perceives it as low.[215]

The offering of favorable liquidated damages clauses allows parties to obtain contracts that would generally not be available to them. Alternatively, for new businesses liberal liquidated damages can be used as a loss leader[216] to gain entry into a market.

The efficiency of liquidated damages clauses was aptly argued by Goetz and Scott.[217] They concluded, "efficiency would be maximized by the enforcement of the agreed allocation of risks embodied in a liquidated damages clause."[218] Efficiency may be advanced both in cases where anticipated damages are difficult to calculate and where they are relatively easy to calculate. In the latter case the parties may negotiate a liquidated damages clause in order to avoid the costs of litigation.[219] In the former case, the parties are attempting to quantify uncertainty by allocating the risks of breach.[220] This rationale for enforcement was cited in the 1999 case of *DAR & Associates, Inc v. Uniforce Services, Inc.*[221] The court reasoned that "[c]ontracting parties have an incentive to negotiate a liquidated damages clause whenever the costs of such a negotiation are less than the expected costs resulting from their reliance on the standard compensatory damages rule for breach of contract."[222]

An argument akin to the "new entrant" rationale previously made is that the parties during their pre-contract negotiations internalize the costs of a potential inefficiency of a penalty clause. Judge Posner made such an assertion in *Lake River Corp.*[223] in arguing that the voiding of penalty clauses is primarily an act of paternalism. "The parties will, in deciding whether to include a penalty clause in their

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[215] Kornhauser, *supra* note 8, at 720 (emphasis in original).
[216] *Supra* Section B.1.
[217] Goetz & Scott, *supra* note 8.
[218] *Id.* at 572.
[219] "It is entirely rational for the parties to use the prepayment fee clause [*qua* liquidated damages] as a device for avoiding a trial." Whitman, *supra* note 141, at 873.
[220] Goetz & Scott, *supra* note 8, at 559.
[221] DAR & Assocs. v. Uniforce Services, Inc., No. 98-CV-409, 1999 U.S. Dist. LEXIS 403 (E.D. N.Y. 1999).
[222] *Id.* at *24.
[223] Lake River Corp. v. Carborundum Co. 769 F.2d 1284 (7th Cir. 1985).

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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 other costs."[224] A logical extension of this argument is that the efficient breach argument is only plausible if the "penalty" designation is based upon a totally internalized accounting of actual damages and not simply those recognized under the common law. The internalization of the full transaction costs of contracting, along with *other costs* such as the costs of litigation and nonpecuniary costs, is needed to make an accurate determination of the efficiency of not enforcing a penalty clause.

3. *Efficiency in Dispute Resolution*

Economic theory holds that party-generated settlements are inherently more efficient than litigation.[225] The court system is subsidized by society. This subsidy means that the costs of litigation are not fully internalized by the contracting parties. As such, litigation is inefficient as compared to alternative dispute resolution, namely settlement negotiation, mediation and arbitration. Litigation is also inefficient due to party induced inefficiency. Litigants have a tendency to grossly overestimate or underestimate damages, which makes settlement more difficult. "After a breach, a victim has an incentive to exaggerate his loss, and the cost of negotiating a settlement or going to trial is high when losses cannot be easily measured."[226]

The rationale that penalty clauses deter the termination of contracts by efficient breach can be attacked on a number of grounds. First, the measure of actual damages recognized under contract law understates the *true actual damages* of the non-breaching party. For example, "by ignoring nonpecuniary losses, the contract damage system fails to compensate plaintiffs fully and thus encourages inefficient breach."[227] Compensatory damages do not fully internalize all the losses of the non-breaching party. The actual

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[224] *Id.* at 1289.

[225] "In the course of drawing up an agreement, the parties may determine in advance the damages that are payable should one party breach the contract. Thus the expense and uncertainty of litigation are avoided and the parties can be sure that their interests are fully protected." Ham, *supra* note 8, at 649.

[226] Rea, *supra* note 8, at 159.

[227] Sebert, *supra* note 44, at 1654.

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damages awarded under the law often do not include attorney's fees,[228] inconvenience, stress, and other pecuniary and non-pecuniary damages.[229] Thus, in reality, the amount stipulated in a penalty clause may be closer to the actual loss than the actual damage calculation found in the law of contracts. The disproportionality between the stipulated sum and actual damages that liquidated damages law abhors is partially a fabrication of the common law's failure to provide remedies that fully internalize all losses. Professor Kornhauser argues that if this is true, "then allowing parties to estimate damages in advance will induce more appropriate decisions in this respect than court-imposed rules."[230] Also, the Coase Theorem and efficient breach theory premises the efficient transfer of entitlements on zero or low transaction costs.[231] In realty, the existence of substantial transaction costs that are borne by the non-breaching party questions the efficiency of the non-enforcement of liquidated damages clauses.

The risk of deterring potentially efficient breaches may be justified in order to protect the non-breaching party's expectancy interest.[232] The common law defines expectancy as the internal profits to be gained through the contract. However, if the expectancy interest is more broadly defined as *opportunity profits*, then the expectancy interest also captures profits external to the contract. In short, the expectancy interest would encompass the lost profits directly emanating from the contract, along with opportunity profits available through an assignment of the contract or a resale of its subject matter. Professor Epstein lends support to this argument when he states that

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[228] *See generally* Virginia G. Maurer et al., *Attorney Fee Arrangements: The United States and Western European Perspectives*, 19 NW. J. INT'L L. & BUS. 273 (1999).

[229] *See generally* Goetz & Scott, *supra* note 8 (courts' unwillingness to compensate for the nonpecuniary losses of breach); *see also* Craswell, *supra* note 8, at 662 ("[T]raditional expectation damages are often under compensatory, compared to an amount that would leave the plaintiff truly indifferent between receiving performance and collecting damages. Consequently, remedies appear *overcompensatory* may in fact be closer to a truly compensatory award.") (emphasis in original).

[230] Kornhauser, *supra* note 8, at 721.

[231] "[T]he famous *Coase theorem*—that given zero transaction costs, the law's assignments of right or liabilities will not affect efficiency." KRONMAN & POSNER, *supra* note 209, at 6 n. 6. *See generally* Coase, *supra* note 194.

[232] *See* Jeffrey L. Harrison, *Trends and Traces: A Preliminary Evaluation of Economic Analysis in Contract Law*, 1988 ANN. SURVEY AM. L. 73, 98.

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"experience and contacts gained from one job often provide the gateway to the second, and these indirect gains are lost if expectation damages are calibrated to the discrete transaction."[233] Viewed from this definition of expectancy, a seemingly overliquidated damages clause may simply be a reflection of the capture of opportunity profits. The risk of deterring inefficient breaches may simply be a reflection of the difficulty of accurately defining or calculating full compensatory damages. If the penalty amount narrows the divergence between actual damages and legally recognized damages, then its enforcement acts to more fully protect the expectancy of the non-breaching party. Further, it would not deter true efficient breaches because it may be a better approximation of actual damages then is provided for under the law.

Another argument against the efficient breach rationale is that instead of deterring breach, the penalty clause will likely encourage settlement. The breaching party will be forced to share some of the surplus produced by the breach with the non-breaching party. In short, the breaching party is motivated to negotiate out of the penalty clause. The Coase Theorem indicates that in the absence of transaction costs "a party who can realize external economic benefits only with the concurrence of another party will bargain with that party and reach an agreement under which the two of them will share the benefits."[234] The non-breaching party can be brought to the

[233] Epstein, *supra* note 3, at 64. Professor Epstein states more assertively: "The commercial morality that allows individuals to make contracts of their own choosing cannot allow people to breach these contracts free of moral stain, with only limited legal consequences." *Id.* at 66.

[234] Whitman, *supra* note 141, at 878; *see also* Lionel D. Smith, *Disgorgement of the Profits of Breach of Contract: Property, Contract and "Efficient Breach"*, 24 CANADIAN BUS. L.J. 121, 133 (1994) ("the Coase Theorem, which says that in the absence of transaction costs, the same social benefits will accrue regardless of where the law places an entitlement"). This seems to have been verified by Beale & Dugdale in their survey of manufacturers. They found that "when a liquidated damages clause had been agreed buyers [did not] seem very keen to make use of the remedy. We were told that often a negotiated settlement would be reached under which only part of the sum due would be paid." Hugh Beale & Tony Dugdale, *Contracts Between Businessmen: Planning and the Use of Contractual Remedies*, 2 BRITISH J. L. & SOC'Y 45, 55 (1975); *cf.* Talley, *supra* note 8 (arguing that non-enforcement of penalty clauses actually induces more efficient contract re-negotiation).

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bargaining table through the *threat of performance*.[235] If the contracted performance provides a given value to the non-breaching party, then any penalty amount over that value would dictate a preference in favor of non-performance. Performance, however, precludes recovery of the penalty and confines the party's gain to the value of the performance. Thus, any sharing of the surplus from an efficient breach that provides the breaching party with a gain over the value of the performance would be preferred over the actual performance. Thus, efficient breach in most instances will be preserved through the use of a portion of the breaching party's surplus to buy out the penalty clause.

An ancillary argument is that in order for efficient breach to work, the breaching party must determine the amount of money that it will need to compensate the other party.[236] The greater the uncertainty of calculating compensatory damages, especially considering the vagaries of juries,[237] the more troublesome becomes the efficient breach decision. In contrast, the uncertainty and transaction costs of predicting such damages is removed by the liquidated damages clause, albeit one that is technically a penalty. Thus, the costs of negotiating an amount below what is stipulated in a penalty clause are less than the "assessment costs of litigation."[238] An efficient

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[235] The "threat of performance" concept was taken from JEFFREY L. HARRISON, LAW AND ECONOMICS 135 (1995). Professor Harrison concludes that because of the threat of performance the non-breaching party "is likely to sell her *right* to liquidated damages." *Id.* (emphasis original).

[236] *See generally* Charles J. Goetz & Robert E. Scott, *Measuring Sellers' Damages: The Lost Profits Puzzle*, 31 STAN. L. REV. 323, 326-28 (1979).

[237] The uncertainty of the results of litigation for breach of contract was described by Eric Posner as follows:

> Parties can reasonably believe that given the varying sophistication of trial judges, lawyers, and juries, the accidents of discovery, the varying credibility of witnesses, the vagueness of the law, and so on, that the chance of winning a breach of contract suit is pretty much random.

ERIC A. POSNER, A THEORY OF CONTRACT LAW UNDER CONDITIONS OF RADICAL JUDICIAL ERROR 13 (Univ. of Chicago, Law & Econ. Working Paper No. 80, 1999).

[238] William S. Dodge, *The Case for Punitive Damages in Contracts*, 48 DUKE L.J. 629, 630 (1999). Professor Dodge argues that recognizing rights to specific performance, punitive damages, and penalties act as property rules. As such, they require the promisor who does not wish to perform to negotiate with the promisee "because they make breaching the contract prohibitively expensive." *Id.* at 667. Professor Dodge ultimately concludes that punitive damages, and not specific performance or penalties, is the most efficient in inducing negotiation.

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breach may be discouraged because of the uncertainty of determining the cost of breach. This is generally because prediction of the results of litigation over damages necessarily imposes error costs. "Voluntary negotiations, on the other hand, do not impose error costs."[239] A penalty clause may actually encourage breach, especially since it is subject to re-negotiation.

4. *Ockham's Razor: Inefficiency in Complexity*

In a previous sub-section, an argument advanced by Professor Rubin was that the common law is inherently efficient. He argued that since inefficient rules are *evolved out* of contract law and since the rule against penalties is longstanding, then the rule is efficient. However, even if efficient, there may be a simpler, more efficient alternative. Complexity in law is inherently inefficient for a number of reasons.[240] Transaction costs are likely to increase as bargaining parties attempt to respond to such complexity through preemption. Complexity in contract law will generally result in uncertainty in the private parties' understanding and application of the default rules. Additional negotiation and drafting time is required in order to bring certainty. This is done by attempting to draft clauses that reduce the range of judicial discretion in reforming the will of the parties.

The inefficiency of unnecessary complexity in the law is an example of *Ockham's Razor.* Ockham's Razor is defined as a rule "that entities should not be multiplied needlessly, meaning that the simplest of two or more competing theories is preferable."[241] The creation of a separate body of rules aimed entirely at overliquidated damage clauses adds undue complexity to contract drafting and dispute resolution.[242] The earlier review of the standards and rules used in

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[239] *Id.* at 675.

[240] *See generally* Peter H. Schuck, *Legal Complexity: Some Causes, Consequences, and Cures*, 42 DUKE L.J. 1 (1992).

[241] THE AMERICAN HERITAGE COLLEGE DICTIONARY 944 (3d ed. 1993).

[242] Professor Mattei argues that the chaos that best describes the state of liquidated damages law necessarily breeds inefficiency in the dispute resolution process. "The insuring party in default will have an incentive to litigate, hoping the court will declare the penalty clause void, rather than buying itself out of the contract by *bribing* the other party. Coasian negotiations do no occur in the presence of unclear property rights." Ugo Mattei, *The Comparative Law and Economics of Penalty Clauses in Contracts*, 43 AM. J. COMP. L. 427, 432 (1995).

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evaluating liquidated damages law showed a chaotic and inefficient jurisprudence. The pre-Code law was unduly cumbersome and vague. This vagueness was carried over to Section 2-718 of the Code.[243] The law as currently constituted is hopelessly splintered and inefficient in making truthful determinations of whether a clause is sufficiently punitive. The complexity is evidenced by the large volume of cases that have been generated over the enforcement of such clauses.[244] Eliminating this unnecessary layer of rules will allow the courts to simply intervene against clauses that are products of unconscionability, mistake, or fraud.

An analogous economic argument is that if the default rules of contract law are deemed inefficient, then parties will attempt to contract around them. A Coasian argument can be made that parties will bargain to reduce the transaction costs of using inefficient rules. Kronman and Posner state that parties will substitute their own rules for the ones supplied by contract laws. "The parties will prefer efficient terms that minimize the costs of the transaction to them, and accordingly the tendency will be to contract around any inefficient rules of contract law."[245] This may explain why parties continue to negotiate liquidated damages clauses despite the constant intervention of the penalty rule.[246] Unfortunately, the courts persist in imposing their view of the appropriate amount of damages.

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[243] Professor Slawson has argued that Karl Llewellyn's technique of drafting encouraged "grand-style judging." To encourage such a style of judging Llewellyn intentionally used vague terms in drafting the Uniform Commercial Code. Slawson singles out Section 2-718(1) as an example of Llewellyn's intentional vagueness.

> One [of Llewellyn's tactics] was to draft the Code in such vague terms that the courts would have no choice but to use their creative powers in deciding cases falling under it. Subsection 2-718(1) is an instance of this tactic. Any-one not already familiar with the common law of liquidated damages would be at a loss for the meaning of this subsection. Its evident purpose is not so much to state the law of liquidated damages as to invoke it.

SLAWSON, *supra* note 55, at 136.

[244] The fact that the law singles out liquidated damages clauses for judicial review invites litigation over their enforceability. White & Summers states that "[t]he Code invites judicial scrutiny of liquidated damages clauses." WHITE & SUMMERS, *supra* note 190, § 4-6, at 145.

[245] KRONMAN & POSNER, *supra* note 209, at 6.

[246] For an analysis that liquidated damages clauses act as simplifying devices to overcome the need for contractual complexity see *infra* Section IV.C.1, "Liquidated Damages Through the Lens of Behavioral Analysis."

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C. *A Theory of Efficient Penalty*

This section will examine a number of rationales that may be used to support the position that enforcing penalty clauses would be both efficient and fair. The following arguments will be presented. First, at least some penalties are essentially efficient. In those situations, the enforcement of such clauses works a redistribution of utility gain between the breaching and non-breaching parties. Ultimately, an efficient breach is not deterred by the existence of the penalty clause. Instead, the penalty clause provides incentive for the parties to negotiate around the penalty clause. Second, the non-enforcement of penalty clauses is seen as creating a reverse penalty. The non-performing party is likely to have paid a premium to have the clause inserted into the contract. If a court subsequently voids the clause, then there remains a possibility that the actual damages recognized by the court may not fully account for the premium paid for the clause. Third, the enforcement of penalty clauses helps fill the gap in common law remedies created by the treatment of specific performance as an extraordinary remedy. An aside will be offered by way of an analogy to the non-enforcement of contractual renewal clauses. This analogy will be used to argue that penalty clauses can be used to deter and compensate for relational opportunism in long-term contracts. Finally, an argument will be constructed from behavioral theory for the enforcement of efficient penalty clauses. In short, penalty clauses can be viewed as a rational response to the uncertainty of contracts.

1. *Efficient Penalties*

It is clear that in some instances the surplus obtained by the breaching party is sufficient to pay the penalty and induce a breach. This can be shown using a simple Pareto Frontier analysis. The Pareto Frontier is the curved line in Exhibit 1.[247] It represents different Pareto-optimal positions. An efficient penalty would produce a Pareto improvement as represented by a move from point *a* to point *b*. The gain from the breach is shared by the breaching

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[247] For a fuller explanation of the concept of the Pareto-optimal frontier or "contract curve," see JULES L. COLEMAN, MARKETS, MORALS AND THE LAW 102-03 (1988).

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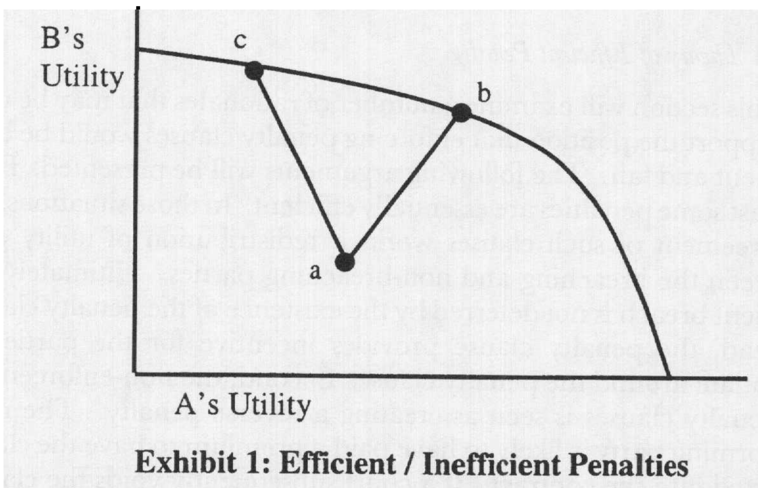

Exhibit 1: Efficient / Inefficient Penalties

party (A) and the non-breaching party (B)—a net utility gain for both. An inefficient penalty is one that would produce a move represented by a shift from point *a* to point *c*. Such a move would be wealth-maximizing from the Kaldor-Hicks perspective since it is a move from a sub-optimal position to a position of Pareto optimality (an increase in total utility, i.e., B's net utility gain > A's net utility loss). However, the surplus to be gained may not be sufficient for the breaching party to earn a net gain after paying the penalty—creating a net loss in B's utility. The penalty induces an inefficient performance. Thus, the parties remain at the sub-optimal point represented by *a*. If one introduces the concept of renegotiation, then it can be argued that even a surplus below an amount that is needed to pay the penalty may be enough to induce a breach. The parties have an incentive to negotiate a movement from point *c* towards point *b*.[248] It is in the interest of the non-breaching party to increase its net utility by negotiating a payment somewhere between its actual damages and the penalty amount. The negotiation produces an efficient penalty

[248] Under the principle of Pareto Optimality neither *b* or *c* can be seen as superior. However, in terms of re-distributive justice, the parties should be allowed to negotiate a move along the curve based upon their subjective valuations. The subjective nature of comparing various Pareto-optimal states was described by Professor Birmingham as follows: "Although choice among Pareto optimal states requires appeal to subjective values, the superiority of at least one such state over any given state outside the set may be defended as almost tautological." Robert L. Birmingham, *Breach of Contract, Damage Measures, and Economic Efficiency*, 24 RUTGERS L. REV. 273, 278 (1970).

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given the amount of surplus to be generated by the breach. From a societal point of view there is no preference, on efficiency grounds, between points *b* and *c*. However, in terms of re-distributive justice, the parties should be allowed to negotiate the move from *c* to *b*. Also, it is not always certain that if the parties fail to negotiate a buy-out of the liquidated damages clause that the efficiency from the deterred breach would necessarily be lost. The performance receiving party may be able to capture the breach surplus by way of a subsequent resale. The net efficiency gain is the same whether obtained by a party through breach or by the receiving party on resale.

2. *Non-enforcement as a Reverse Penalty*

In the event that the liquidated damages clause was a negotiated term of the contract, the law of liquidated damages provides a windfall to the breaching party. Economic theory suggests that the contract price is directly influenced by the parties' bargained for risk allocation.[249]

Thus, the non-breaching party would generally pay a premium for the insurance provided by a liquidated damages clause. The ex post voiding of the clause by a court serves as a penalty in reverse. The breaching party benefited from earning a higher contract price for providing illusory insurance in the form of an unenforceable liquidated damages clause.

The *reverse penalty* assertion is premised upon the argument that the efficiency of the breach is skewed by the fact that the cost of the liquidated damages clause was incorporated into the price of the contract being breached. It is possible that the increased contract price may narrow the market price-contract price differential used by the courts in assessing actual damages. The courts are likely to adopt a market price that does not incorporate the costs of the liquidated damages clause. In way of illustration, suppose the contract price (market price) at the time of contract formation for a good would normally be set at $1000. Assuming the seller's cost of production and delivery is $800, the seller's profit will be $200. Efficient breach theory dictates a breach at the time the seller is offered an amount by

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[249] The rationale of risk allocation has been used in support of limitation of liability clauses under Section 2-719 of the Uniform Commercial Code. *See, e.g.*, JOM, Inv. v. Adell Plastics, Inc., 151 F.3d 15, 28 (1st Cir. 1998).

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another party that will enable him to create a surplus above the amount needed to fully compensate the non-breaching party. Full compensation under American law is often viewed as the difference between the contract price and the market price at the time of breach or between the contract price and the price of substituted goods (normally as limited by the market price at the time of substitution).[250] For example, Section 2-713 of the Uniform Commercial Code states that upon the non-delivery or repudiation of the seller, "the measure of damages . . . is the difference between the market price at the time when the buyer learned of the breach and the contract price."[251] If the market price does not include the premium paid for the penalty clause, then there is a substantial danger of an inefficient breach. Assuming the market price for the good has escalated subsequent to the contract formation to $1200, an efficient breach for a contract without the penalty premium would be some amount above a $1200. For example, a third-party offer of $1201 would enable the seller to fully compensate the buyer by paying contract damages of $200 (contract-market price differential). The seller would retain the surplus of $1, along with his profit margin of $200.

Assume now that the contract provides a penalty for breach in an amount equal to seller's original profit margin of $200 and the penalty clause resulted in an increase in the contract price to $1050. If the penalty clause were enforceable, then an efficient breach would not present itself until the market price reached $1251. At $1251, the seller could pay the penalty of $200 and retain the additional $1. If the market fails to increase to $1250, then an opportunity for efficient breach is lost. This is the efficiency argument against the enforcement of penalty clauses. However, if the penalty clause is voided ex post under the law of liquidated damages, then a different scenario is created. Non-enforcement creates an artificial reduction in the *actual*

[250] "By and large in contract cases the standard of valuation considered is market value in contradistinction to any peculiar value the object in question may have to the owner." CALAMARI & PERILLO, CONTRACTS, *supra* note 90, § 14-12, at 536.

[251] U.C.C. § 2-713 (1977). This section further states that the buyer may collect "any incidental and consequential damages provided in this Article." An argument could be made, by the buyer, that the premium paid for the penalty clause should be refunded as a consequential or incidental damage. However, such damages are not within the Code's definition of consequential or incidental damages. *See* U.C.C. §2-715 (1977). The remedy available for the buyer's cover (procuring substituted goods) is the "difference between the cost of cover and the contract price." U.C.C. § 2-712 (2) (1977).

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damages recognized under the law. With a market price of $1200, actual damages would be reduced to $150 ($1200-1050). An offer of $1251 would enable the seller to *fully compensate* the buyer ($150) and retain his base profit of $200, the phantom premium of $50, and the $1 surplus. If for some reason the seller wanted to use the phantom premium (for other than economic reasons), it would be able to accept an offer below the market price. A third-party offer of $1150 would enable the seller to pay the buyer's compensatory damages of $150 ($1200-1050) and still obtain its base profit of $200. A seller voluntarily giving up $50 of profit for no apparent reason would seem fantastic. Nonetheless, one could envision a scenario where the scarcity of a good, coupled with the idiosyncrasies of relationships, would lead a party to terminate an existing relationship at a loss in order to build a new relationship. In essence, the penalty premium could be used to fund a loss leader needed to obtain another customer. One thing is clear, however; the non-enforcement of a penalty clause results in a reverse penalty against the non-breaching party through the initial inflation of the contract price. Alternatively, the breaching party is allowed to keep a premium despite the canceling of the risk insurance embodied in the liquidated damages clause.

The breach in an inflationary market, as highlighted above, is opportunistic in nature. A breach in a deflationary market is likely to be involuntary in nature. It is in this market where the punitive nature of a penalty becomes most apparent. Assume a contract price of $1050 ($1000 plus the $50 premium) and a penalty clause providing for $200 upon breach. If the market price declines to $900 subsequent to the contract formation, the non-breaching party would benefit from non-performance. If the seller performs, then the buyer would suffer a $150 loss (contract-market price differential). Any breach from the seller's perspective would be non-opportunistic because he would be forgoing a premium contract price given the fall in the market price. Any breach would be involuntary. Nonetheless, the breach would trigger the $200 penalty. If enforced, the buyer would save $150 by entering the market by purchasing at the market price of $900. The buyer would also earn an additional windfall of $200. In this situation, the penalty operates in a clearly punitive manner. The key issue is whether this scenario justifies the current law that invalidates all penalty clauses or is merely an example of an inefficient penalty. As such, the law is too broad in its sweep. One can also pose a scenario where an intentionally overliquidated

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damage amount is used not to punish but to reward and is, therefore, inherently efficient. For example, a performing party may be rewarded a stipulated amount for early performance.[252] Given the fact that the intention approach has been generally discarded, the clause would technically be unenforceable even though it does not have an *in terrorem* purpose.

3. *Penalties as a Specific Performance Substitute*

The fact that the common law views specific performance as an extraordinary remedy provides a further argument against the continuation of the law of liquidated damages as currently constituted.[253] One reason for the parties' agreement on a penalty clause may be the recognition of the idiosyncratic value placed on performance by one of the parties. If that is the case, then the performance is unique to that party, even though it is not the type of uniqueness needed to obtain a decree of specific performance.[254]

The idiosyncratic uniqueness of the performance can only be protected by the enforcement of the penalty. Also, the non-breaching party deprived of a specific performance remedy should not be forced into litigation in order to quantify damages. In the civil law system, where specific performance is viewed as a preferred remedy, the non-breaching party has the option of avoiding the vagaries and uncer-

[252] *See, e.g.*, Paul Rosta, *Fast Work Earns Big Bonus*, ENGINEERING NEWS RECORD, Apr. 18, 1994 ("For early completion, the agency set a bonus or liquidated damages of $200,000 per day, and [the contractor's] bonus nearly doubled its $14.9-million contract award.").

[253] The *ICC Guide* alludes to this when it states that "[s]ometimes a sum payable under a penalty-liquidated damages clause may be the only way in which a contract can be enforced, as in some legal systems [common law] specific performance may not be available." ICC GUIDE, *supra* note 74, at 19.

[254] The uniqueness requirement in the law of specific performance is generally an objective determination. The focus is on the uniqueness of the item (of the contract) itself. Idiosyncratic uniqueness focuses on the subjective value placed upon performance by the non-breaching party. The trade literature has recognized this function of liquidated damages clauses. *See, e.g.*, Mark D. Eisemann, *Liquidated Damages: Not A Watered Down Remedy*, J. PROP. MGMT., July/Aug. 1991, at 68. "It is an added benefit because, by definition, liquidated damages is not specific performance. However, it is this byproduct—the added leverage to induce the tenant to specifically perform in order to avoid the payment of the liquidated damages sum—which is most appealing to landlords." *Id.*

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tainty of quantifying damages.[255] Contractual devices, such as liquidated damages, offer greater remedial flexibility in the common law's anti-specific performance remedy structure. It can be viewed as a semi-legal substitute for the equitable remedy of specific performance. To the extent that the liquidated damages clause maintains the contractual relationship, it acts as a self-help form of specific performance. If the penalty is efficient and results in a breach, then the supracompensatory nature of the penalty can be seen as compensation for the non-breaching party's inability to demand specific performance.[256]

4. *An Acontextual Comment: Relational Opportunism*

Professor Narasimhan has argued that renewal clauses in contracts should be strictly enforced.[257] Furthermore, she argues that in some instances of relational opportunism[258] the law should imply renewal

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[255] Ugo Mattei has noted that "efficient breach theory" has been ignored within the civil law system. This is hardly surprising for a system that more broadly enforces penalty clauses and views specific performance as an ordinary remedy. Mattei states that "[o]n policy grounds it is not that clear that efficient breaches should be encouraged by a legal system. . . . This is the reason why most legal systems of the civil law tradition tend to resist efficient breaches, and why they have traditionally assigned a more central role to specific performance than has common law." Mattei, *supra* note 242, at 429.

[256] It has been argued that the theory of efficient breach, along with the rules against specific performance and penalty clauses, "encourages uncivil, unilateral, uncooperative attitudes towards contractual relationships." TREBILCOCK, *supra* note 181, at 142. A reversal of the default rules, ones favoring the granting of specific performance or the enforcement of penalty clauses, would result in a fairer sharing of the benefits of the breach. Instead, the current default rules "deprive the non-breaching part of the possibility of sharing in the gains from the new opportunity presented to the breaching party, which a negotiated release from an entitlement to specific performance [or to a penalty] would probably engender." *Id.* at 142.

[257] Subha Narasimhan, *Relationship or Boundary? Handling Successive Contracts*, 77 CAL. L. REV. 1077 (1989).

[258] "Relational opportunism" recognizes that long-term contractual relationships may produce certain values, costs, and dependencies not found in more transactional types of contracting. *See generally* Benjamin Klein et al., *Vertical Integration, Appropriate Rents, and the Competitive Contracting Process*, 21 J. L. & ECON. 369 (1978); Robert E. Scott, *Conflict and Cooperation in Long-Term Contracts*, 75 CAL. L. REV. 2005 (1987). A cost of long-term contracts is that the parties may develop a reliance on the continuation of the contract. This type of reliance may be considered a "quasi rent." "Reliance is evidence of investments made by a party in the relationship and, hence, evidence of the existence of *appropriate quasi rents* that yield the potential for exploitation by the other party." Narasimhan, *supra* note 257, at 1105 n.80 (emphasis in original).

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rights. The analysis developed by Professor Narasimhan can be utilized to argue for the enforcement of penalty clauses. First, a penalty clause can be seen as a buy-out of a long-term contract. This can be done expressly by incorporating a liquidated damages provision within a renewal or non-renewal clause. Or more implicitly, a court may connect a non-renewal with a separate liquidated damages clause. Since the relational costs implied in relational opportunism are generally not recognized under common law damages, the courts should be more liberal in enforcing a so-called penalty in order to compensate for these relationally idiosyncratic losses. Putting it another way, a liquidated damages clause may appear to be a penalty when viewed from the perspective of a discrete transaction. However, it would be reasonable from the perspective of the long-term relationship that entails a series of past and future discrete undertakings. Second, penalty clauses should be enforced as a party-agreed means to deter relational opportunism. The enforcement of a penalty can be justified if Narasimhan is correct in her assertion that "relational opportunism in negotiating successor contracts . . . can lead to socially wasteful hold-up behavior."[259] Alternatively, not enforcing clauses that the parties negotiate in order to deter opportunism and assure long-term contractual commitments will deter efficient contract formation. Not enforcing liquidated damages clauses inserted for these reason in order to protect efficient breach opportunities may prevent the parties from entering the contract in the first place.

The law on the enforcement of renewal clauses exhibits a number of similarities found in the law of liquidated damages, namely, an inherent bias against enforcement. As a rule, generally worded renewal clauses, just like vaguely worded liquidated damages clauses, are likely to be stricken on "grounds of uncertainty."[260] Instead of this practice, Narasimhan argues for a presumption in favor of enforcing such clauses as a reflection of the parties' expressed intentions. The rationale given for enforcement is similar to that offered for enforcing liquidated damages clauses. For example, the internalization of cost argument, offered by Judge Posner in *Lake River Corp.* and discussed in an earlier sub-section, is made on behalf of enforcement. The

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[259] *Id.* at 1079.
[260] *Id.* at 1102.

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insertion of such a clause "suggests that the parties have identified a relational value worth preserving, adjusted the price accordingly, and taken the risk of costly negotiations and enforcement of the renewal term. Thus, the parties have themselves indicated that they believe relational values exist that are worth the cost of enforcement."[261] Implied in this internalization rationale is that a renewal clause is unlikely to deter efficient breach; it merely inflates the cost of breach to reflect the non-pecuniary losses discussed previously. The recognition of the parties' intent to provide for renewal requires that the court imply a fair renewal term, instead of simply voiding the renewal clause.[262] This is the same argument that will be made in Part V, namely, that reformation should be made available to courts when enforcing liquidated damages clauses. Also, the enforcement of a renewal clause, like a liquidated damages provision, will generate re-negotiation that will likely result in a sharing of the breaching party's opportunistic surplus.[263]

5. *Liquidated Damages Through the Lens of Behavioral Analysis*

Efficient breach theory implies rational decision-making on the part of the contracting parties at the time of contract and at the time of breach.[264] In reality, rational decision-making, premised upon complete information and minimal transaction costs, is at best a

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[261] *Id.* at 1103.

[262] *Id.* at 1105.

[263] "The knowledge that the renewal right will be enforced . . . will in itself encourage the parties to reach agreement." *Id.* at 1105. She further reasons that "there is little doubt that the legal right of enforcement will change the bargaining positions of the parties, strengthening the hand of the person who will profit by continuing the relationship while weakening that of the one who will benefit by termination." *Id.* Narasimhan argues that non-enforcement of a renewal clause works a redistribution of wealth. "[I]f the parties believe that the term creates legal rights, treating the renewal clause as if it has no effect is just as redistributive as imposing a term in the absence of agreement." *Id.* at 1106. This is similar to the argument that non-enforcement of a liquidated damages clause works a "reverse penalty."

[264] Professor Ham provides a number of rationales for freedom of contract, one of which strikes at the center of efficient breach theory: "Proposition 2: Breach is optimal if it potentially allows a Pareto-improvement over performance." Ham, *supra* note 8, at 655. Moreover, it has been argued that most rules, both legal rules and party-constructed rules, become efficient over time. "There is a strong presumption that principles of commercial and contract law – especially long-established principles – are economically efficient." Rubin, *supra* note 8, at 243.

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random occurrence. The negotiation of a contract is generally made "under conditions of profound uncertainty."[265] Inserting a liquidated damages clause into a contract is one method for dealing with *conditions of profound uncertainty*. Behavioral decision theory offers insights into how contracting parties deal with such uncertainty. These insights into the decision-making processes of contracting parties help inform the rules of contract law. The relevant question for the present analysis is can behavioral analysis be used to assess the law of liquidated damages, namely the non-enforcement of penalty clauses.

In a 1997 article, Cass Sunstein reviewed the findings of behavioral research.[266] The following analysis uses those findings to construct an argument for the enforcement of penalty clauses. For example, parties often view contractual rights as entitlements; as such, they are likely to view a breach by the other party as a loss of an entitlement.[267] This notion of *loss aversion* holds that the non-breaching party will value a loss greater than those who acquire the entitlement.[268] Thus, even if common law damages were truly compensatory, the non-breaching party will value the loss due to the breach greater than an equivalent gain from the granting of contract damages. Behavioral decision theory refers to this as the *endowment effect*.[269] A liquidated damages clause amount above fully compensatory damages may simply be a reflection of this endowment effect.

Efficient breach theory assumes that contracting parties act solely in pursuit of self-interest.[270] In fact, *norms of fairness* often impact their

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[265] RICHARD A. POSNER, VALUES AND CONSEQUENCES: AN INTRODUCTION TO ECONOMIC ANALYSIS OF LAW 5 (Univ. of Chicago Law & Econ. Working Paper (2d Series) (1998)).

[266] Cass R. Sunstein, *Behavioral Analysis of Law*, 64 U. CHI. L. REV. 1175 (1997); *cf.* Hillman, *supra* note 11.

[267] "People are especially averse to losses. They are more displeased with losses than they are pleased with equivalent gains." Sunstein, *supra* note 266, at 1179.

[268] "[T]he allocation of the legal entitlement may well matter, in the sense that those who are initially allocated an entitlement are likely to value it more than those without the legal entitlement." *Id.*

[269] "The legal entitlement creates an endowment effect . . ." *Id.* at 1180. *See generally*, Daniel Kahneman et al., *Experimental Tests of the Endowment Effect and the Coase Theorem*, 98 J. POL. ECON. 1325 (1990).

[270] In fact, economic theory, as represented by the norm of efficiency, is a foundational rationale of much of contract law. "[E]veryone [is] held to the standard of that *rational, efficient, reasonable person*." Richard E. Speidel, *The New Spirit of Contract*, 2 J.L. & COM. 193,

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decision-making processes.[271] "[P]eople may want to act fairly and perhaps more importantly, they want to be seen to act fairly."[272] Agreeing to supracompensatory liquidated damages may be a product of the fairness norm. The parties, in essence, agree ex ante that opportunistic breach should be deterred. Alternatively, the *fairness of the breach* is improved by the breaching party's willingness to share some of the surplus generated by the breach.[273] Furthermore, the payment of a supracompensatory amount may have a positive *reputation effect.*[274] Such a payment endows the breaching party with a claim of acting fairly. As such, this may not only preserve the breaching party's general business reputation, but may also allow for future contracts with the non-breaching party.

From an ex ante perspective, behavioral analysis informs us that liquidated damages clauses may have positive effects on contract formation.[275] A liquidated damages clause may increase the comfort level of one of the parties in order to trigger a decision to enter into the contract. For example, the clause may be used to overcome certain *availability heuristics*.[276] A party may have had a recent negative experience involving a breach of a similar contract. The availability heuristic explains that "people tend to think that risks are more serious when an incident is readily called to mind or *available*."[277] The liquidated damages clause can be seen as a device to overcome this over-evaluation of risk. A supracompensatory damages amount will help overcome the negative effect of the previous experience. Furthermore, it may make the party truly indifferent to a performance or breach result. In essence, the risk of a similar negative

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197 (1982) (emphasis added).

[271] *See generally* DiMatteo, *supra* note 14, at 444-45.

[272] *Id.* at 1186. The term, *bounded self-interest*, has been used to describe the role of fairness concerns in self-interested decision-making. *See generally* CHRISTINE JOLLS ET AL., A BEHAVIORAL APPROACH TO LAW AND ECONOMICS (Univ. of Chicago, Law & Econ. Working Paper (2d Series) No. 55, 1998).

[273] "Economists sometimes assume that people are self-interested. . . . But people also may want to act fairly . . ." Sunstein, *supra* note 266, at 1186.

[274] People sometimes act fairly because "they want to be seen acting fairly." *Id.*

[275] For example, a liquidated damages clause may allow a prospective contracting party to overcome his "ambiguity aversion" due to the uncertainty of outcome in a future breach of contract suit. *Id.* at 1191.

[276] An availability heuristic refers to the tendency that people will weigh risks more seriously "when an incident is readily called to mind or *available*." *Id.* at 1188.

[277] *Id.* at 1188 (emphasis in original).

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experience is reduced to zero.[278] Also, persons have an aversion to ambiguity or uncertainty. The previous discussion of the "undercompensatory" nature of common law damages may place a dampening effect upon a party on the borderline of a decision to enter or not to enter into a contract. This ambiguity aversion is placated when damages are fixed ex ante.

If the contracting parties are aware of their cognitive shortcomings in predicting future opportunities or damages, then they may elect to negotiate a liquidated damages clause as a method of simplifying their contract. Instead of incurring the costs of negotiating a complex contract that attempts to deal with all possible future occurrences, the parties may view the liquidated damages clause as a simplifying device. "[I]f parties recognize their own cognitive limitations, and thus realize that drafting a contract anticipating almost all possible contingencies would require exorbitant time and mental effort, then they are unlikely to find complexity cost-effective."[279] This recognition of their own *bounded rationality* allows the parties to reduce transaction costs through the use of clauses that respond well to the reality of bounded-rationality. Clauses pertaining to liquidated damages, renegotiation, open price, escalation, rights of first refusal, and excuse reduce the need for the parties to anticipate all future consequences within their contract. Thus, behavioral analysis can be used, if not to justify the enforcement of liquidated damages and penalty clauses, then to understand why they are so popular.

V. REFORMING THE LAW OF LIQUIDATED DAMAGES

The current law of liquidated damages is premised on the belief that penalty clauses are *per se* unfair. If it can be shown that some penalty clauses are indeed fair, then the rationale for the current law is severely flawed. The previous section demonstrated that a number of efficiency arguments support the enforceability of penalty clauses. The next step entails how best to reform the law of liquidated damages. Any remedial response should entail eliminating the specialized law of liquidated damages and returning it to the main body of contract doctrine. The proper remedial change is suggested in the following statement of an Australian court. "[I]n the present

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[278] Sunstein refers to this as the *all or nothing* risk preference. *Id.* at 1191.

[279] KAREN EGGLESTON ET AL., SIMPLICITY AND COMPLEXITY IN CONTRACTS 30 (Univ. of Chicago, Law & Econ. Working Paper (2d Series) No. 93, 2000).

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state of authority there is neither an appropriate basis to take into account the nature of the transaction and the relationship of the parties, nor is there means of providing partial relief. If the clause is characterized as a penalty it is unenforceable *ab initio*."[280] Recognizing the *nature of the transaction* and the *relationship of the parties* suggests the use of unconscionability as the primary mechanism for policing liquidated damages clauses. The importance of *partial relief* requires granting the courts the option to reform excessive liquidated damages clauses. This section will review the general rules found within the Uniform Commercial Code pertaining to liquidated damages, limitation of liability, unconscionability, and impracticability in order to support the elimination of Section 2-718. A review of the proposed changes to the Revised Article 2-718 finds them wanting. This section concludes by suggesting that reformation should be the preferred remedial response to excessive liquidated damages clauses, and reviews the English Law Commission's Contract Code that comes to a similar conclusion.

A. *Uniform Commercial Code's Model of the Contractual Exchange: The Attempt to Serve Two Masters – Efficiency and Fairness*

The current law of liquidated damages fails to advance the concerns of contractual fairness and efficiency. This section will examine the feasibility of using existing policing doctrines to control the enforcement of penalty clauses. The use of the doctrine of unconscionability is an especially strong candidate if one asserts that rational parties would not agree to an unreasonable penalty clause. Ex ante unreasonable liquidated damages clauses may be a product of mistake or procedural unconscionability.[281] If the parties did not consciously intend to create an unreasonable stipulated amount, then it was likely a product of mistake. If the parties consciously created an ex ante unreasonable stipulated amount, then it is a likely product of unconscionability. It is the conscious creation of an unreasonable liquidated damages clause that the next section will discuss.

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[280] Citicorp v. Hendry, 4 N.S.W.L.R. 1, 23-24 (1985).

[281] Rea, Jr., *supra* note 8, at 160 ("there will be few cases in which the damages were ex ante unreasonable and in which there is no evidence of mistake or unconscionability").

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1. *The Interrelationship Between Sections 2-718 and 2-719*

Generally, the commentary has treated Section 2-718 (Liquidation of Damages) and Section 2-719 (Limitation of Liability) as wholly independent. However, the notes to the Revised Article 2 help illustrate that such a view is an overly simplistic one.[282] Section 2-718 is primarily aimed at dealing with overliquidation. The final sentence of Paragraph 1 is of special note. It singles out overliquidation as a special concern: "A term fixing unreasonably large liquidated damages is void as a penalty."[283] This allows for the possibility that an underliquidated damages clause could be treated as a limitation of remedy under Section 2-719. An earlier draft of the Revised Article 2 provides insight into to this interrelationship. Note 3 to the new Section 2-718 indicates that an underliquidated damages clause, if viewed as an arbitrary amount, could be treated as a limitation of remedy clause under Section 2-719.[284] Note 1 of Section 2-719 (Contractual Modification of Remedy) states that a limitation of remedy clause that is considered severe may be treated as a penalty. It notes that there is an unanswered question of "how far such agreements may go in varying the standard remedies for breach of contract."[285] It questions "at what point does an agreed remedy become a penalty or sink below some minimum adequate remedy?"[286] Its only answer is that a greater latitude is given in commercial transactions, especially to "highly sophisticated business entities."[287]

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[282] Professor Burgess provided an interesting classification of exemption clauses under English law. His classification clearly demonstrates that such clauses are generally similar in nature as they are to be treated under the law pertaining to form contracts. His classification discusses three general subclasses: limitation clauses, exemption clauses, and exclusion clauses. He further breaks limitation clauses into three types: qualitative limitations (limitation of remedy), quantitative limitations (liquidated damages), and procedural limitations (notice, statute of limitation provisions). Andrew Burgess, *Consumer Adhesion Contracts and Unfair Terms: A Critique of Current Theory and a Suggestion*, ANGLO-AM. L. REV. 255, 260-62.

[283] U.C.C. § 2-718(1) (1977).

[284] U.C.C. § 2-719 (1977).

[285] REVISED ARTICLE 2 – SALES § 2-810, at 159 (discussion draft 1997).

[286] *Id.* at 159-60.

[287] *Id.* at 160 (citing Canal Elec. Co. v. Westinghouse Elec. Corp, 973 F.2d 391 (1st Cir. 1992)).

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Another interesting proposition is whether section 2-718's reasonableness test should also apply to limitations of liability clauses. The First Circuit held in the 1998 case of *JOM, Inc. v. Adell Plastics, Inc.* that the "reasonableness test is inapplicable to damages-limitation clauses" which are solely covered under Section 2-719.[288] Under Section 2-719, a limitation of remedy may be voided if it fails to provide a remedy consistent with the *essential purpose* of the contract.[289] The general premise of the essential purpose principle is that a sales contract may limit the types of remedies available, but must make available some "minimum adequate remedy."[290] An underliquidated damages clause can be analyzed through the prism of the essential purpose doctrine of Section 2-719. The non-breaching party would argue that the clause actually serves as a limitation of remedy and fails to provide a minimum adequate remedy. Alternatively, a limitation of remedy clause can be viewed as a "reverse" penalty clause which Section 2-718 is formulated to handle.

At the philosophical level, the judicial attitude towards the liquidated damages clauses compared to limitation of remedy clauses is difficult to reconcile.[291] Other than the limitation of the "essential

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[288] 151 F.3d 15, 37 (1998).

[289] Section 2-719(2) states that "[w]here circumstances cause an exclusive or limited remedy to fail of its *essential purpose*, remedy may be had as provided in this Act." Comment 1 of the section defines "essential purpose" as providing a "fair quantum of remedy" or "minimum adequate remedies." *See generally* Jon Eddy, *On the "Essential" Purposes of Limited Remedies: The Metaphysics of UCC 2-719(2)*, 65 CAL. L. REV. 28 (1977).

[290] Marr Enterprises, Inc. v. Lewis Refrigeration Co., 556 F.2d 951, 955 (9th Cir. 1977); *see also* Jones & McKnight Corp. v. Birdsboro Corp., 320 F. Supp. 39 (D. Ill. 1970); Neville Chem. Co. v. Union Carbide Corp., 294 F. Supp. 649 (D. Pa. 1968); Adams v. J.I. Case Co., 161 N.E.2d 1 (Ill. App. 1970).

[291] "The judicial attitude to clauses which impose onerous liabilities on the party in breach is in marked contrast to case law in relation to clauses which minimize liability, generally known as exclusion clauses or exemption clauses." Hoy, *supra* note 38, at 244. Professor Threedy provides the following litmus test for demarcating 2-718 and 2-719: "When the clause is for the benefit of the nonbreaching party, it should be analyzed under Section 2-718. When the clause is for the breaching party's benefit, however, it is actually a limitation on damages and should be analyzed under Section 2-719." Debora L. Threedy, *Liquidated and Limited Damages and the Revision of Article 2: An Opportunity to Rethink the U.C.C.'s Treatment of Agreed Damages*, 27 IDAHO L. REV. 427, 457 (1990). This covert understanding of an "underliquidated" liquidation of damages clause *qua* limitation of remedy clause demonstrates the inherent confusion generated by the different standards and remedies provided by these two articles. Threedy concludes that "it would help alleviate the confusion between Sections 2-718 and 2-719 if the standard for enforceability was the same under each." *Id.* at 458.

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purpose doctrine," courts have generally been amenable to the enforcement of limitation of remedy clauses. In the area of sales law, "repair, replace, or refund" limitations have been accepted as reasonable limitations of remedy clauses. In contrast, liquidated damages clauses, which serve similar purposes, have been disfavored by the courts. The rationale given for this is that courts want to maintain their role in providing appropriate remedies for contractual breach.[292] However, this rationale fails because courts may be equally limited in resolving contract disputes when upholding limitation of remedy clauses. In *Global Octanes Texas, L.P. v. BP Exploration & Oil,*[293] the plaintiff alleged damages totaling $28 million. However, a contract provision stated that "in no event shall the liability of either party exceed $500,000."[294] Judge Higginbotham labeled this limitation as one within the purview of Section 2-719 and not Section 2-718.[295] As such, he declared two fundamental premises upon which its enforcement was warranted. First, "[u]nder Texas law, contracting parties can limit their liability in damages to a specified amount."[296] Second, "it is immaterial whether the limitation of liability is a reasonable estimate of probable damages resulting from a breach."[297] He rejected the plaintiff's argument that because of the large disparity between the limitation amount and actual damages the clause should be voided under Section 2-718. The rationale given was that "[a] liquidated damages provision sets a fixed amount that can be recovered upon breach without proof of *any* damage. A limitation of damages provision limits the damages that may be recovered, but proof of damages is still required in order to recover

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[292] Calamari and Perillo give the historical rationale for courts not enforcing penalty clauses as follows:

> The answer seems to be that in general parties are free to enter into a contract containing whatever terms they wish regarding the establishment of primary rights, but except within narrow limits they are not free to determine what remedial rights will be provided. Remedies are provided by the state and are defined by public rather than private law.

CALAMARI & PERILLO, *supra* note 90, § 14-31, at 564.

[293] 154 F.3d 518 (5th Cir. 1998).

[294] *Id.* at 521.

[295] "Paragraph 11 is a limitation of damages and not a liquidated damages provision." *Id.* at 523.

[296] *Id.* (quoting Vallance & Co. v. Anda, 595 S.W.2d 587, 590 (Tex. Civ. App. 1980)).

[297] *Id.*

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to the limit."[298] He concluded that the unreasonableness of the limitation was therefore irrelevant.[299] The reed of distinction between a clause that provides a fixed amount versus one that provides a fixed cap is a thin one. First, on the facts of this case, the vast disparity between the alleged actual damages of $28,000,000 and the cap of $500,000 renders the cap a fixed amount of liquidated damages. Second, the statement that proof of damages is not a factor in the enforcement of liquidated damages clauses fails to recognize the reality of the law of liquidated damages. The reasonableness standard inevitably results in one of the parties proving actual damages in order to show a disparity with the amount stipulated in the liquidated damages clause.

The favored treatment of limitation of remedy clauses, as compared to liquidated damages clauses, is also difficult to justify on efficiency or public policy grounds. It has been argued that liquidated damages clauses provide an incentive to render a quality performance, while limitation of liability or remedy clauses have the opposite effect. The stipulated sum in a liquidated damages clause can be seen as reflecting the subjective value of the non-performing party; as such, there is no efficiency reason for treating it differently than any other substantive term in the contract. In effect, the additional consideration paid by the non-performing party can be seen as transforming the right to performance from a contract right to a property right. Viewed as a way of safeguarding a property right, liquidated damages clauses provide "efficient incentives to keep promises."[300] In contrast, limitation of liability or remedy clauses limit the performing party's exposure and in some instances can weigh in favor of encouraging poor performances and inefficient breaches. If the limitation of liability clause is set at an amount below expectancy damages, then breach will be triggered at inefficient levels. The breaching party may seek other opportunities, while the non-breaching party is left undercompensated.

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[298] *Id.* (quoting Tharalson v. Pfizer Genetics, Inc., 728 F.2d 1108, 1101 (8th Cir. 1984)).

[299] "[I]t is immaterial whether a limitation of liability is a reasonable estimate of probable damages resulting from a breach." *Id.* at 521 (quoting Vallance & Co. v. Anda, 595 S.W.2d 587, 590 (Tex. Civ. App. 1980)).

[300] Mattei, *supra* note 242, at 431. The analysis in this paragraph is partially borrowed from Professor Mattei's accounting.

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2. *Section 2-302—The Doctrine of Unconscionability*

Section 2-302 of the Uniform Commercial Code authorizes the court to void a contract or clause that it deems to be unconscionable.[301] The sweeping nature of Section 2-302, as compared to the singular focus of Section 2-718, makes it a viable alternate means of analyzing liquidated damages clauses. The California Law Revision Commission aptly noted the breadth of unconscionability when it addressed the issue of the enforceability of liquidated damages clauses. The Commission's Comment to Section 1671 of the California Civil Code lists the following factors to be used in the determination of the reasonableness of a liquidated damages clause: the relationship of the damages specified to the harm that could have reasonably been anticipated, the equality of the bargaining power of the respective parties, representation by counsel at the time of contracting, whether the parties anticipated that a determination of actual damages would be difficult or expensive to calculate, the difficulty of establishing foreseeability, and whether the provision was in a form contract.[302] This approach was utilized by the Ohio Supreme Court in *Samson Sales, Inc. v. Honeywell, Inc.*[303] In that case, the contract incorporated a clause limiting the damages for breach by an installer of a security system to fifty dollars.[304] The court offered the following rationale for voiding the clause:

> [A]n examination of the minute type used in the standard contract issued by [the defendant], as well as a fair construction of the contract provision as a whole, fails to evince a conscious intention of the parties to consider, estimate, or adjust the damages that might reasonably flow from the negligent breach of the agreement. ... therefore, the nominal amount set forth in the contract ... has the nature and appearance of a penalty.[305]

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[301] "[T]he court may refuse to enforce the contract, or it may enforce the remainder of the contract without the unconscionable clause, or it may limit the application of any unconscionable clause as to avoid any unconscionable result." U.C.C. § 2-302(1) (1977).

[302] *See* Trust Co. for USL v. Wein Air Alaska, Inc., No. 96-15222, 1997 U.S. App. LEXIS 11958, at *9-10 (9th Cir. Mar. 12, 1997).

[303] 465 N.E.2d 392 (Ohio 1984).

[304] The contract stated that the "Company's liability, if any, shall be limited to the sum of $50 as liquidated damages and not as a penalty and this liability shall be exclusive." *Id.* at 393.

[305] *Id.* at 394 (citing American Fin. Leasing Co. v. Miller, 322 N.E.2d 149 (Ohio 1974)).

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The court used traditional procedural unconscionability factors in concluding that the parties had not intended to estimate damages as required under the law of liquidated damages.[306] The intertwining of liquidated damages law and the doctrine of unconscionability was evident in *Equitable Lumber Corp. v. IPA Land Development Corp.*[307] "The Court of Appeals recognized that a contractual provision might be unenforceable if the agreed [attorneys'] fee is so unreasonable that it 'serves as a penalty rather than a good faith attempt to pre-estimate damages' *or* as to be unconscionable."[308]

Instead of carving an exception to the adequacy of consideration doctrine[309] for liquidated damages clauses, the enforceability of penalties should be made expressly subject to the general policing mechanism of unconscionability.[310] A contract that was the product of severe bargaining inequality, especially when a standard form was used, should be carefully analyzed for substantive unconscionability. For example, in *Aero Consulting Corp. v. Cessna Aircraft Co.*[311] the District Court noted that the liquidated damages clause provided for an

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[306] The court stated that the enforceability of the liquidated damages clause was dependent on whether "the contract as a whole is not so manifestly unconscionable . . . as to justify the conclusion that it does not express the true intention of the parties." *Id.* at 394 (quoting Jones v. Stevens, 112 Ohio St. 43, 146 N.E. 894 (1925)).

[307] 381 N.Y.S.2d 459 (1976).

[308] This is a quote from Judge Kaplan's commentary on the *Equitable Lumber* case in *Korea First Bank v. Lee,* 14 Supp. 2d 530, 533 (S.D.N.Y. 1998). Although Judge Kaplan noted that an attorneys' fee clause must meet both the tests of unconscionability and the penalty doctrine, it provides another example where the unconscionability doctrine and liquidated damages law are used side by side.

[309] The principle of adequacy of consideration is that "the law will neither inquire into the adequacy of consideration nor, as a rule, offer relief from what has turned out simply to be a bad bargain." Ham, *supra* note 8, at 661.

[310] The elimination of the law of liquidated damages in favor of the doctrine of unconscionability can be seen as efficient:

> As with any attempt to correct a failure of the market, the most efficient approach is to address the problem as directly as possible. In [the case of penalty clauses], this means examining the bargaining process and the relationship of the parties (via the doctrines of duress and unconscionabilty) rather than looking merely at the end product, the agreed sum.

Id. at 669. Professor Threedy has argued that the negotiated-adhesion distinction should be the template for a new law of liquidated damages. "As with overcompensatory damages, the inquiry should not focus on the reasonableness of any amount set, but on whether the contract is negotiated or one of adhesion." Threedy, *supra* note 291, at 460.

[311] 867 F. Supp. 1480 (D. Kan. 1994).

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award "in an amount slightly less than ten per cent of the total purchase price."[312] As such, it concluded that the liquidated damages amount was not so unreasonably large as to act as a penalty.[313] Alternatively, the clause would have been enforced under the doctrine of unconscionability because it was not *substantively* unconscionable.[314] Regarding the proportionality of the stipulated damages to actual damages, the court in *Ledbetter Brothers v. North Carolina Department of Transportation* held that a divergence between the two should render the clause a penalty *only* if "the disproportion [is] such as to shock the judicial conscience."[315] The court in *Ridgley v. Topa Thrift & Loan Association*[316] stated that a liquidated damages clause is to be considered reasonable unless "it bears no reasonable relationship to the *range* of actual damages that the parties could have anticipated would flow from the breach."[317]

In contrast, a case involving a liquidated damages clause in an automobile lease displayed all of the characteristics of unconscionability. Procedural unconscionability was evidenced by the inequality of bargaining between the lessor and the lessee, including the use of the lessor's standard rental agreement and the lack of independent counsel for the lessee. The clause was substantively unconscionable since it provided for liquidated damages "based on the sum of *all* remaining and past due lease payments, of residual end-of-term balance that lessee would have to pay to purchase the vehicle, of costs of assigning lease, and of payment equal to one month's rent."[318] The clause was voided as a penalty, but could have easily been discarded under the doctrine of unconsionability.

The intermixing of the traditional penalty analysis and unconscionability factors was demonstrated in *Matlock Rental Co. v. Lift-All, Inc.*[319] The court found significant the fact that the liquidated

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[312] *Id.* at 1494.

[313] *Id.*

[314] The court expressly stated that "the liquidated damages provision . . . was reasonable;" as such, it can not support a claim of unconscionability. *Id.* at 1493.

[315] 68 N.C. App. 97, 107, 314 S.E.2d 761 (N.C. 1984).

[316] 27 F. Supp. 2d 1377 (M.D. Fla. 1998).

[317] *Id.* at 1383 (emphasis added); *see also* Phillips v. Phillips, 820 S.W.2d 785 (Tex. 1991) (agreement to pay a multiple of actual damages is an unenforceable penalty).

[318] *In re* Dailey, 167 B.R. 932, 935 (D. Mont. 1994).

[319] No. 97-2786, 1998 U.S. Dist LEXIS 14094 (E.D.Pa. 1998).

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damages clause was "based upon a preset formula contained in a preprinted from and . . . that the formula was not based upon any calculation of damages unique to the instant case."[320] A 1999 District Court decision, once again, isolated procedural unconscionability factors in assessing the reasonableness of a liquidated damages clause. "[W]hen analyzing the reasonableness of a liquidated damages provision, the court *must* consider the sophistication of the parties and whether both sides were represented by able counsel who negotiated the contract at arms length without the ability to overreach the other side."[321] In short, explicit bargaining over the liquidated damages clause is evidence that the parties consciously understood the meaning of the clause and thus the development of the clause was procedurally conscionable. The court ultimately held that the liquidated damages clause was enforceable because it did not "shock the moral sense,"[322] and thusly was substantively conscionable.

Once again, in *Bigda v. Fishbach Corp.*, a court applied unconscionability factors in upholding a liquidated damages clause in an employment contract.[323] The court reviewed the clause in terms of a *totality of the circumstances* analysis stating that "due consideration must also be given to the nature of the contract and the *attendant circumstances*."[324] The attendant circumstances were "whether the parties were sophisticated and represented by counsel, the contract was negotiated at arms-length between parties of equal bargaining power, and similar damages provisions were incorporated in other employment contracts."[325] The court seems especially comfortable in applying the unconscionability analysis to the issue of the enforceability of a liquidated damages clause. What is more surprising is the fact that the court, on its own terms, applied this analysis when it could have easily decided the issue under liquidated

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[320] *Id.* at *14.

[321] DAR & Associates, Inc. v. Uniforce Services, Inc., No. 98-CV-409, 1999 U.S. Dist. LEXIS 403, at *30 (E.D. N.Y. 1999) (quoting Wilmington Trust Co. v. Aerovias de Mexico, 893 F. Supp. 215, 218 (S.D.N.Y. 1995)); *see also* Pacificorp Capital, Inc. v. Tano, Inc., 877 F. Supp. 180, 184 (S.D.N.Y. 1995).

[322] 1999 U.S. Dist. LEXIS 403, at *31 (quoting Hackenheimer v. Kurtzmann, 192 N.Y.S. 181, 182 (1921)).

[323] 849 F. Supp. 895, 902-03 (S.D.N.Y. 1994).

[324] *Id.* at 902 (emphasis added); *see also* Wilmington Trust v. Aerovias de Mexico, 893 F. Supp. 215 (S.D.N.Y. 1995).

[325] 849 F. Supp at 902.

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damages law. It need not have performed the unconscionability analysis because it found that the stipulated sum was a reasonable estimate of anticipated loss.[326] The court in *Hartford Fire Ins. v. Architectural Mgt.*[327] was even bolder in failing directly to apply liquidated damages law. It simply stated that such clauses are enforceable "if the parties expressed their agreement in clear and explicit terms and there is no evidence of fraud or unconscionable oppression."[328]

A comment to Section 2-718 recognizes the use of the doctrine of unconscionability when a clause underliquidates the damages. An arbitrary distinction is made between under and overliquidated damages clauses. "Section 2-718 provides that an unreasonably large liquidated damages (overliquidation) is void as a penalty, and the Comment speculates that an unreasonably small amount might be stricken under the section on unconscionable contracts or clauses."[329] The rationale for such a distinction is not given.[330] The party challenging the enforcement of such a clause must overcome the burden of proof presented by the higher threshold of

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[326] "A liquidated damages clause should not be deemed a penalty because the balance between actual and probable damages turns out not to be perfectly or flexibly proportioned." *Id.*

[327] 550 N.E.2d 1110 (Ill. App. 1990).

[328] *Id.* at 1114; *see also* Potomac Elec. Power Co. v Westinghouse Elec. Corp., 385 F. Supp. 572 (D.D.C. 1974). An argument against supplanting the unconscionability doctrine for the rule against penalties was offered to me by Professor Rita Marie Cain. In short, despite the potential breadth of the unconscionability doctrine courts generally only apply it to consumer transactions. Therefore, there is a fear that penalties will not be fully policed in commercial transactions. My response is threefold. First, nothing in the law prevents the courts from applying the doctrine to commercial transactions. Second, the courts have on occasion voided clauses in merchant to merchant contracts under the rubric of unconscionability. *See, e.g.*, Construction Assoc., Inc. v. Fargo Water Equip. Co., 446 N.W.2d 237 (N.D. 1989). Third, due to the fact that courts have demonstrated a bias against enforcement, they may be more willing to use unconscionability to invalidate penalties if Section 2-718 is eliminated.

[329] Dow Corning Corp. v. Capitol Aviation, Inc., 422 F.2d 622, 626 (7th Cir. 1969).

[330] In contrast, Section 2-719 expressly defers to the limiting principle of unconscionability. Section 2-719(3) allows for a limitation clause prohibiting the collection of consequential damages. Its states that "consequential damages may be limited or excluded unless the limitation or exclusion is *unconscionable.*" U.C.C. § 2-719(3) (1977). Section 2-719(3) does preempt any exclusion of consequential damages for personal injury in the area of consumer goods as *per se* unconscionable.

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unconscionability.[331] Liquidated damages clauses, however, are subject to challenge through the lower threshold of the reasonableness standard.[332]

The elimination of Section 2-718 in favor of a general policing of such clauses through the doctrine of unconscionability would restore symmetry to the law of contracts. The asymmetry of the law of liquidated damages is apparent at two levels. At the level of contract theory, the singling out of such clauses for judicial scrutiny is an exception to freedom of contract's presumption of enforceability.[333] The law of liquidated damages is also internally asymmetrical. Currently, overliquidated damages clauses are void under Section 2-718 as illegal penalties, while underliquidated clauses are generally analyzed under the unconscionability doctrine.[334] The rationale for applying two different standards to liquidated damages clauses remains unpersuasive. A true penalty would likely be void under unconscionability, while a fair or efficient penalty would be enforced. The chaotic law of liquidated damages, multiple prongs and all, could be jettisoned in favor of the more generic doctrine of unconscionability.

The use of the unconscionability standard can be bolstered by the assertion that not all "penalties" are per se unreasonable. There may be legitimate reasons why the parties agree to a penalty clause. A penalty may be needed to provide deterrence when the probability of detecting non-performance is uncertain. For example, the detection of violations of a franchise agreement may be low due to the difficulty

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[331] The unconscionability principle requires more then a finding that a contract or a contract clause is unreasonable or simply unfair. "The principle is one of the prevention of oppression or unfair surprise." U.C.C. § 2-302, cmt. 1 (1977).

[332] "Under subsection (1) [of § 718] liquidated damage clauses are allowed where the amount involved is reasonable in the light of the circumstances of the case." U.C.C. § 718 cmt. 1 (1977).

[333] "[T]he law of contract was designed to provide for the enforcement of the private arrangements which the parties had agreed upon. . . . As applied to the law of contract these ideas meant encouraging almost unlimited freedom of contracting. . ." ATIYAH, *supra* note 121, at 9.

[334] "A term fixing unreasonably large liquidated damages is expressly made void as a penalty. An unreasonably small amount would be subject to similar criticism and might be stricken under the section on unconscionable contracts or clauses." Tharalson v. Pfizer Genetics, Inc., 728 F.2d 1108, 1112 (8th Cir. 1994).

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of monitoring the day to day operations of the franchisee.[335] Thus, the parties may increase the liquidated damages amount to take into account the probability of detection or enforcement. To have the necessary deterrent effect, the amount will need to be somewhat punitive in nature. However, the current law voids all penalties whether reasonable or unreasonable.

Finally, general economic theory provides an argument for the use of the unconscionability doctrine to police liquidated damages clauses. Procedural unconscionability analysis is a recognition that the economic antecedents of complete information and perfect competition are often lacking in contractual undertakings.[336] Instead, the contract may reflect a certain degree of inequality of bargaining. In the event that the inequality of bargaining produces a sufficiently one-sided contract, then the law must intervene to compensate for the inequality.[337] In short, the contract was not a product of rational negotiation. Unfortunately, the law of liquidated damages does not account for such a procedural analysis. Therefore, clauses that are the product of rational negotiation are voided as well as those that are the products of irrational decision-making.

The current law of liquidated damages employs a balancing approach in defining whether the pre-estimate of damages is sufficiently disproportionate to actual damages to warrant a finding of unreasonableness. If the difficulty of proof is high, so is the acceptable disproportionality allowance between actual damages and those provided for in the clause.[338] It is this notion of disproportionality that places the law of liquidated damages outside of the mainstream of freedom of contract. It can return to the body of contract doctrine by the replacement of disproportionality with

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[335] Rea, *supra* note 8, at 155-56.

[336] Factors used in a procedural unconscionability analysis focus on facts that the contract negotiation was not the product of full information and perfect competition. For example, relevant to most unconscionability inquiries "is whether the parties were sophisticated and represented by counsel, the contract was negotiated at arms-length between parties of equal bargaining power." Bigda v. Fischbach Corp., 849 F. Supp. 895, 902 (S.D.N.Y. 1994).

[337] Comment 1 to UCC § 2-302 states that "[t]he basic test is whether, in the light of the general commercial background and commercial needs of the particular trade or case, the clauses involved are so one-sided as to be unconscionable." U.C.C. § 2-302 cmt. 1 (1977).

[338] *See* RESTATEMENT (SECOND) OF CONTRACTS § 356 cmt. b (1984) ("If the difficulty of proof is great, considerable latitude is allowed in the approximation of anticipated or actual harm.").

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unconscionability. The reasonableness standard, in which mere disproportionality is often the basis for voiding a clause, would be stricken. Instead, the more difficult threshold provided under the doctrine of unconscionability would need to be satisfied in order to void the clause.

The threshold for unconscionability was recently recognized and restated in *Siemens Credit Corp. v. Newlands*.[339] "Unconscionability has generally been recognized to include the absence of meaningful choice [procedural unconscionability] on the part of one of the parties together with contract terms which are unreasonably favorable to the other party [substantive unconscionability]."[340] *Unreasonably favorable* is then defined by the court as something much greater than an amount that is merely disproportionate to actual damages. "A (substantively) unconscionable bargain has been defined as one that 'no man in his senses would make on the one hand, and no honest and fair man would accept on the other.'"[341] The clause must be so disproportionate as to shock the conscience or be considered "monstrously harsh."[342]

Moreover, the convergence between the disproportionality standard in the law of liquidated damages and the standard of unconscionability can be seen in the concept of *grossly disproportionate*. The merely disproportionate standard as a substitute for grossly disproportionate was rejected by the court in *Rattigan v. Commodore International Ltd.*.[343] It recognized the breaching party's argument that the stipulated sum was disproportionate to the potential loss. However, it rejected the argument and enforced the liquidated damages clause stating that: "Nonetheless, the liquidated damage provision is not *grossly disproportionate* to what the parties reasonably could estimate as the anticipated probable loss from breach."[344] The

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[339] 905 F. Supp. 757 (N.D. Cal. 1994).

[340] *Id.* at 764 (quoting A & M Produce v. FMC Corp., 135 Cal. App. 3d 473, 486, 186 Cal. Rptr. 114 (1982)).

[341] *Id.* at 765 (partially quoting Hume v. United States, 132 U.S. 406 (1889)).

[342] *Id.* at 765 (citing Garrett v. Janiewski, 480 So. 2d 1324, 1326 (1985)).

[343] 739 F. Supp. 167 (S.D.N.Y. 1990).

[344] *Id.* at 170 (emphasis in original); *see also* Truck Rent-A-Center, Inc. v. Puritan Farms, 361 N.E.2d 1015 (Ct. App. 1977). "It is plain that a provision which requires, in the event of contractual breach, the payment of a sum of money *grossly disproportionate* to the amount of actual damages provides for penalty and is unenforceable." *Id.* at 1018 (emphasis added).

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difference between grossly disproportionate and substantive unconscionability seems to be thin at best and meaningless at worst.

3. *Analogy: Doctrine of Impracticability*

The courts' determination of the reasonableness of liquidated damages clause are usually made outside the scope of a traditional "totality of the circumstances analysis."[345] Whether the clause was a product of negotiation or simply inserted in the fine print of a form produced by one of the parties is generally immaterial. If a totality analysis finds that the liquidated damages clause formed a part of the "basis of the bargain," then shouldn't the court be discouraged from voiding such a clause? The law of liquidated damages is inherently flawed because it does not adequately assign an important role in the enforcement decision to the fact that a clause was a *dickered term*.[346]

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[345] For a fuller explanation of the totality of the circumstances analysis, see DiMatteo, *supra* note 14.

> In determining what a reasonable person in the position of the contracting parties would have intended, the courts look to the specific characteristics of the parties and the circumstances surrounding the formation of their contract. . . . The sophistication of the parties, including their personal or institutional understanding of the meaning [of the contract]. ... The sophistication, knowledge, and experiences of the contracting parties become pivotal elements in the construction of the reasonable person. . . . Beyond the four corners of the contract and the party-specific analysis, the courts often look to the totality or surrounding circumstances of the contract. . . . The reasonable person [interpretation of the contract] is to be "determined by the totality of the circumstances, including the comparative abilities of the parties to make informed judgments . . . , each party's interest . . . , and the extent to which the interest was a factor in the negotiation of the contract."

Id. at 318-20 (partially quoting *In re* Westinghouse Elec. Corp. Uranium Contracts Litig., 517 F. Supp. 440, 456 (E.D. Va. 1981)).

[346] "Dickered terms" was made famous by Karl Llewellyn in his exposition on the differences between dickered and boilerplate terms in standard form contracts. The first type is enforceable as a reflection of specific assent, the later may be enforceable under the notion of *blanket assent*. He described the notion of blanket assent as applied to standard form contracts as follows:

> Instead of thinking about "assent" to boiler-plate clauses, we can recognize that so far as concerns the specific, there is no assent at all. What has in fact been assented to, specifically, are the few dickered terms, and the broad type of transaction, and but one thing more. That one thing more is a blanket assent (not a specific assent) to any not unreasonable or indecent terms the seller may have on his form, which do not alter or eviscerate the reasonable meaning of the dickered terms.

KARL N. LLEWELLYN, THE COMMON LAW TRADITION 370 (1960).

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An example of incorporating a basis of the bargain analysis into the enforcement determination is found in the area of excuse. If the provision produces a remedially oppressive result, it can be argued that it has been *frustrated.*[347] In the law of excuse, frustration of purpose is often an implied condition that occurrence or non-occurrence of an event was a basis of the bargain.[348] The case for a basis of the bargain analysis is even stronger when dealing with liquidated damages clauses because the clause is an express term of the contract. In some instances the liquidated damages clause is a product of deliberate negotiation.

The use of reformation in the area of impracticability can be used, by analogy, to argue for the judicial reformation of liquidated damages clauses. Under the common law doctrines of impossibility and frustration, the courts generally rescind the contract and release the parties from any further obligations. In contrast, the Uniform Commercial Code's doctrine of impracticability has evidenced a more flexible judicial response.[349] Courts have been more willing to ignore the easier "all or nothing approach"[350] of rescission in favor of equitably reforming the contract. The general intent of the parties to enter a contractual relationship is given priority.

The paradoxical nature of the judicial response in withholding enforcement of liquidated damages clauses can be found in Section 2-615's requirements for granting excuse under the doctrine of impracticability. It provides relief when an unexpected event destroys the basis of the bargain as agreed to in the contract. It does, however,

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[347] Frustration generally goes to the fact that the purpose for a contract no longer exists or has been frustrated. The excuse of frustration remains the primary excuse doctrine in Great Britain. In contrast, it has been largely transplanted by the doctrine of impracticability codified in Section 2-615 of the Uniform Commercial Code. For a lengthy discussion of the doctrine of frustration, see ATIYAH, *supra* note 121, at 245-62.

[348] The notion of an implied condition as the basis for granting the excuse of frustration has been widely noted. "[T]here is the imposition of a constructive condition . . . [w]here the object of one of the parties is the basis upon which both parties contract, the duties of performance are constructively conditioned upon the attainment of that object." CALAMARI & PERILLO, *supra* note 90, § 13-10 at 495.

[349] *See generally* Thomas R. Hurst, *Freedom of Contract in an Unstable Economy: Judicial Reallocation of Contractual Risks Under U.C.C. 2-615*, 54 N.C. L. REV. 545 (1967); Note, *Contractual Flexibility in a Volatile Economy: Saving U.C.C. Section 2-615 from the Common Law*, 72 NW. U. L. REV. 1032 (1978).

[350] *See generally* Robert W. Reeder III, *Court-Imposed Modifications: Supplementing the All-Or-Nothing Approach to Discharge Cases*, 44 OHIO ST. L.J. 1079 (1983).

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provide one crucial caveat. Relief should not be granted if the parties had allocated in the contract the risk of the occurrence of such unexpected events.[351] A liquidated damages clause can be seen as such a risk allocation device. Through such a clause, the parties have agreed to quantify the amount of damages at risk when the contract is breached, whether through malice or due to an unexpected occurrence. If the court decides that there had been no such risk allocation, then it can be argued that the doctrine of impracticability could be brought to bear in order to grant an excuse. In essence, the liquidated damages clause was frustrated by conversion into a penalty clause by an unexpected event or non-occurrence. The granting of the excuse could include a rescission of the contract, thus rendering the liquidated damages clause inoperable. Alternatively, the court could use the reformation remedy provided under the doctrine of impracticability to re-write the liquidated damages clause. This potential interrelationship between the doctrine of impracticability and Section 2-718 has never been adequately explored in the case law or in the commentary. The question remains whether Section 2-615 can be used to reform liquidated damages clauses. The final sub-sections include analysis of recent attempts at reformulating the law of liquidated damages: Revised Article 2-718 and the English Law Commission's *Contract Code*. Among the issues discussed is the use of reformation as a response to instances of over and underliquidation.

B. *The Revised 2-718*

The courts, long before the enactment of Section 2-718 of the Uniform Commercial Code, disfavored the enforcement of liquidated damage clauses. The rationales given for non-enforcement were often historical in nature.[352] The resultant codification of liquidated damages law in Section 2-718 of the Uniform Commercial Code failed to provide a more rational justification for the non-enforcement of such clauses. It has generated a body of case law that lacks comprehension and is remiss of uniformity. This sub-section will

[351] *See, e.g.*, Transatlantic Fin. Corp. v. United States, 363 F.2d 312 (D.C. Cir. 1966).

[352] *See, e.g.*, Law of forfeiture and use of penal bonds. One rationale that has been offered is that courts view fabricating contract remedies as solely within the judge's domain. "Awarding damages is the principle means by which courts exercise their enforcement authority." MARVIN A. CHIRELSTEIN, CONCEPTS AND CASE ANALYSIS IN THE LAW OF CONTRACTS 173 (2d ed. 1993).

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review the changes proposed by the Revised Article 2.[353] As expected, the chaos of the current law was evident enough to gain the attention of the various reporters and drafting committees.[354]

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[353] Article Two of the Uniform Commercial Code has been under revision for the better part of a decade. The Permanent Editorial Board of the Uniform Commercial Code, in September 1987, initially approved an exploratory committee to investigate whether Article 2 was in need of revision. For past drafts of Revised Article 2, see The National Conference of Commissioners on Uniform State Laws, *Drafts of Uniform and Model Acts: Official Site*, *at* http://www.law.upenn.edu/library/ulc/ulc.htm (last modified Apr. 30, 2001). For reasons other than improving the law, the revision process has not culminated in approval. Despite the approval of the final draft of the Revised Article 2 by the American Law Institute, the final approval was scuttled in May 1999 at the urging of the National Conference of Commissioners on Uniform State Laws. The reason given was despite the American Law Institute's belief that the revision "reflected a fair and balanced treatment," the National Conference determined that "more work is needed to achieve a statute capable of uniform enactment." *ALI and NCCUSL Announce New Drafting Committee for UCC Articles 2 and 2A* (Aug. 18, 1999), *at* http://www.nccusl.org/pressrel/ucc2a2.htm (copy on file with the author); *see also* Linda J. Rusch, *A History and Perspective of Revised Article 2: The Never Ending Saga of a Search for Balance*, 52 SMU L. REV. 1683 (1999).

[354] It is also worthy of note that liquidated damages provisions are found elsewhere in the law. For example, Article 2A's liquidated damages provision is a much more streamlined version of Section 2-718(1). It simply states that:

> Damages payable by either party for default, or any act or omission, including indemnity for loss or diminution of anticipated tax benefits or loss or damage to lessor's residual interest, may be liquidated in the lease agreement but only at an amount that is reasonable in light of the *then anticipated harm* caused by the default or other act or omission.

U.C.C. § 2A-504(1) (1977) (emphasis added). The fact that this is a more recent law then Article 2, indicates that the drafters did not think highly of the tripartite test found in section 718(1). The only one that remains is the test of reasonableness at the time of contracting. There is no recognition that *disproportionality* between the stipulated amount and actual damages is a ground for invalidating a clause. Another example of a modification of liquidated damages law can be found in the Uniform Computer Information Transaction Act (UCITA) (formerly, the proposed Article 2B of the Uniform Commercial Code). Section 804 of UCITA reads as follows:

> (a) Damages for breach of contract by either party may be liquidated by agreement in an amount that is reasonable in light of the:
> (1) loss anticipated at the time of contracting,
> (2) actual loss, or
> (3) actual or anticipated difficulties of proving loss in the event of breach.

UNIFORM COMPUTER INFORMATION TRANSACTIONS ACT, http://www.law.upenn.edu/bll/ulc/ucita/cita10st.htm (last modified Oct. 25, 1999). The "or" indicates that any one of the three tests may be used to enforce a clause. This is yet another variation of the standards currently found in Article 2's section 718(1). The variations found in these different statutes only add to the confusion in this area of the law

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A Discussion Draft for the Revised Article 2 makes a number of changes in the three-pronged approach. First, the anticipated or actual harm requirement language has been modified by the phrase "in light of *either*/or."[355] The insertion of the word "either" clarifies the issue as to whether the clause has to be reasonable regarding both anticipated and actual damages or reasonable as to one of those benchmarks. The either/or language indicates that if it is reasonable as to either of the two perspectives, then it should be enforced. Thus, if the clause amount is unreasonable regarding anticipated damages, but due to some unexpected occurrence the actual damages approximate the amount in the clause, then the clause would be enforced. The new Section 2-718 retains the notion of the "difficulties of proof of loss" as bearing on the reasonableness determination; however, it is has been moved from its current position. Currently, under Section 2-718 a reasonableness determination is made "in light of the anticipated or actual harm caused by the breach, the difficulties of proof of loss, and the inconvenience or nonfeasibility of otherwise obtaining an adequate remedy."[356] The "difficulties of proof of loss" element reads as one factor to be used in the reasonableness determination. A recent revision of Article 2 states that the reasonableness determination is to be made "in the light of the difficulty of proof of loss in the event of breach, either the actual . . . or the loss anticipated."[357] This juxtapositioning of the difficulty of loss element does not seem to substantively change the standard of review. But it can be argued that in the current version, the difficulty of proof element is one of only a number of elements that *may* be considered in the labeling of a liquidated damages clause as a penalty. In contrast, the positioning

and provide a further argument for the elimination of all specialized laws pertaining to liquidated damages.

[355] REVISED ARTICLE 2 – SALES § 2-810, at 156 (discussion draft, Apr. 14, 1997) (emphasis added).

[356] U.C.C. §2-718(1) (1977).

[357] In this revision UCC 2-718 was renumbered and titled as "2-809. Liquidation of Damages; Deposits." REVISION OF UNIFORM COMMERCIAL CODE ARTICLE 2 – SALES, http://www.law.upenn.edu/bll/ulc/ucc2/ucc2399.htm (discussion draft, Mar. 1, 1999). In a more recent revision, the old title and numbering was used and the juxtapositioning of the "difficulty of proof" element was eliminated. *See* REVISION OF UNIFORM COMMERCIAL CODE ARTICLE 2 – SALES, http://www.law.upenn.edu/bll/ulc/ucc2/21299.htm (discussion draft, Dec. 1999) (hereinafter the "December 1999 Draft").

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of the proof of loss element before "in the light of" elevates it to a required element that must be directly confronted by the interpreting court.

The Revised Article 2 eliminates the third prong for situations other than consumer transactions. "[I]nconvenience or nonfeasibility of otherwise obtaining an adequate remedy" has been removed as a factor in determining the reasonableness of the liquidated damages clause in commercial transactions.[358] Thus, proof that it would be inconvenient or nonfeasible for a merchant to obtain an adequate remedy is rendered immaterial. Professor Rusch asserts that the elimination of this element for commercial contracts "strengthens the role of agreement about remedies, such as liquidated damages."[359] She argues that the current law requires a finding of nonfeasibility or inconvenience in order to enforce a liquidated damages clause.[360] The revision allows for the enforcement of liquidated damages clauses in a non-consumer contract "without regard to the inconvenience or nonfeasibility of obtaining an adequate remedy."[361] The opposite seems to be true; the fact of nonfeasibility or inconvenience is one more element that a party can use to bolster its case for enforcement. Under the current law, feasibility or convenience of obtaining a remedy does not automatically preclude enforcement if the clause is otherwise reasonable.[362] However, the existence of nonfeasibility or inconvenience weighs in favor of the reasonableness of a clause. The element is retained in the case of a consumer contract. It can be assumed that its retention in the consumer contract is intended to be protective of the consumer interest. If the party seeking enforcement is the consumer, then the nonfeasibility/inconvenience element can be used bolster its case. This would seem to support the contention that removal of this element in commercial contracts may make enforcement more difficult. In a case where a merchant is attempting to enforce a clause against a consumer, it could also argue because of

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[358] The December 1999 Draft uses the following conjunction: "and, in a consumer contract." *Id.*

[359] Rusch, *supra* note 353, at 1709.

[360] *Id.* at 1709-10.

[361] *See* December 1999 Draft, *supra* note 357.

[362] They are considered as factors in making the reasonableness determination. Section 2-718(1) "sets forth explicitly the elements to be *considered* in determining the reasonableness of a liquidated damage clause." U.C.C. § 2-718 cmt. 1 (1977) (emphasis added).

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the relatively small size of the breach of contract claim it would be nonfeasible or inconvenient to pursue actual damages. This would bolster the merchant's efforts to enforce the clause against the consumer.

Finally, the language that a clause "fixing unreasonably large liquidated damages is void as a penalty" has been deleted from the revised Article 2.[363] Its deletion elicits the question whether *under*liquidation of damages should be construed as a penalty against the non-breaching party. The concern that a clause would subject the breaching party to a penalty was at the heart of the old "unreasonably large" language. Note 3 to Section 2-718[364] states that "suppose commercial parties negotiated a reasonable liquidated damage amount of $5000 but the actual damages were $100,000. This agreement may be enforceable as reasonable liquidated damages, even though the damages were under liquidated."[365] However, the insertion of "reasonable" begs the question of whether the law is directed more at overliquidated damages clauses than at underliquidated clauses. This illustration merely shows the nature of the "either/or" language. The illustration assumes that $5000 was a reasonable estimation of anticipated damages and therefore it satisfies the reasonableness requirement. The fact that the determination of actual damages results in the clause becoming a gross underliquidation is immaterial. The note further supports the supposition that the UCC is primarily concerned with overliquidations. It further states that if the $5000 provision could be construed as a nonliquidation, then it would be measured under Section 2-719 as a limitation of remedy provision. Finally, note the use of "commercial" to describe the parties in the illustration. Even though the drafters rejected a proposal for a special consumer rule, the commercial-consumer distinction seems to be of factual importance in the determination of reasonableness.[366]

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[363] U.C.C. 2-718(1) (1977).

[364] UNIFORM COMMERCIAL CODE REVISED ARTICLE 2–SALES (discussion draft, Apr. 14, 1997).

[365] *Id.* § 2-810, at 157.

[366] Interestingly, the drafters elected to make such a distinction in Section 2-810 "Contractual Modification of Remedy." Section 2-810(b) (2) states that: "In a consumer contract, an aggrieved party may reject the goods or revoke acceptance and, to the extent of the failure, may resort to all remedies provided in this article despite the terms of the agreement." *Id.* at 159.

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Earlier drafts of Revised Article 2 demonstrate the uneasiness that Section 2-718 continues to present. The January 1996 Draft restates the conclusion that reasonableness as to anticipated or actual loss is strictly an "either/or" proposition.[367] Note 1 provides that "the liquidation need only be reasonable in light of anticipated *not* actual loss."[368] Thus, a clause that was a reasonable estimate of anticipated loss is not voided when subsequent events cause the stipulated amount to be disproportionate to the actual loss. However, this version also provides that "[I]n a consumer contract, a term fixing unreasonably large or small liquidated damages is void as a penalty."[369] This would seem to contradict the "either/or" language. The determination of unreasonably large or small can be viewed as a retrospective determination with actual loss as its guide. This inconsistency is made clear in the July 1996 Draft.[370] In that draft the "unreasonably large or small" language is retained. However, the reference to "in a consumer contract" is deleted to make it applicable to all liquidated damages clauses.[371] Note 1 to the July Draft confirms the fact that the "either/or" language is not conclusive. It states that "a term that at the time of contracting looks reasonable can be reviewed in light of actual damages caused by the breach."[372] Eventually, the clause dealing with the notion of "unreasonably large or small" was deleted in its entirety. The changes that are proposed in the Revised Article 2 continue the chaotic jurisprudence that surrounds the current version. It would be best, for the reasons previously presented, to conclude that the liquidated damage provision found in Section 2-718 be eliminated from the revised Article 2. If it fails to be eliminated in the final draft, then state legislatures should be encouraged to eliminate it when updating their state's version of the Code.

As important as the issue of when a liquidated damage clause is to be construed as a penalty, is the issue of the appropriate response to a clause judged to be a penalty. The March 1999 Draft of the

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[367] *See* PART 7–REMEDIES, http://www.law.upenn.edu/bll/ulc/ucc2/text7.htm (working redraft, Jan. 1996).

[368] *Id.* § 2-710 n.1.

[369] *Id.* § 2-710(a).

[370] *See* ARTICLE 2 – SALES: PROGRESS REPORT TO NCCUSL, http://www.law.upenn.edu/bll/ulc/ucc2/ucc20596.htm (Richard Speidel reporter, July 1996).

[371] *Id.* § 2-710(a).

[372] *Id.* § 2-710 n.1.

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Revised Article 2 states that "[i]f a term liquidating damages is unenforceable under this subsection, the aggrieved party has the remedies provided in this article."[373] This statement forbids a court from reforming the clause to make it reasonable. Note 1 adds further support to this interpretation of the language. "A suggestion that a court should have the power to fix damages [within] the liquidation clause was not acted on."[374] Why remove the power of the court to salvage or reform the liquidated damages clause? This is especially puzzling in cases where the clauses were negotiated between two relatively sophisticated commercial parties. If the parties' intentions were clear that they wanted to liquidate damages, then the courts should be allowed to make the necessary adjustments and prevent the type of litigation that the parties had hoped to avoid. The next section will continue the argument for reformation as a preferred response.

C. *Reformation as a Way to Reconcile the Law of Liquidated Damages with Freedom of Contract*

One avenue for bringing the law of liquidated damages into conformity with freedom of contract principles is to re-institute the basis of the bargain. This could be done by allowing courts to reform unreasonable clauses. If the parties truly intended to provide an alternative to litigation through the incorporation of a liquidated damages clause, then this intent should be recognized. Instead of voiding the clause, courts should be allowed to reduce or increase the stipulated amount of the clause in order to reach the threshold of reasonableness.

It can be argued that reformation is an impractical and overly simplistic option.[375] First, the parties have the ability to settle the claim in order to avoid litigation. Second, since the case has proceeded to litigation, the court is in a position to assess actual damages. In response, if the court is mandated under Section 2-718 to determine what is not a reasonable estimate of anticipated harm,

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[373] REVISION OF UNIFORM COMMERCIAL CODE ARTICLE 2 – SALES § 2-809(a), http://www.law.upenn.edu/bll/ulc/ucc2/ucc2399.htm (Mar. 1, 1999).

[374] *Id.* at 157.

[375] Professor William H. Henning posed this argument. Professor Henning is currently the chair of the drafting committee of the Revised Article 2. William H. Henning, THE EMERGED AND EMERGING NEW UNIFORM COMMERCIAL CODE (ALI-ABA ed., 1999).

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then shouldn't it also be able to determine what would have been a reasonable estimate? The usefulness of the remedy of reformation was recognized, in dicta, by the court in *Brecher v. Laikin*:[376]

> The Court has considered an apportionment of the total liquidated damage clause as to allow partial recovery for a breach of one of four separate obligations...such an apportionment might be proper, albeit somewhat novel, remedy. In this case, however, lacking any legal authority for apportionment of a unitary liquidated damage figure, defendant must demonstrate his actual damage in order to recover for the breach.[377]

If reformation were made an option, the parties would be able to provide evidence to assist the court in its determination of a reasonable stipulated sum.[378] For example, evidence of trade custom or usage involving such clauses could provide a range of reasonableness.[379] Finally, the international analysis of such clauses[380] provides examples of the application of reformation to liquidated damages clauses. In fact, most foreign legal systems prefer reformation instead of the outright voiding of such clauses.

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[376] 430 F. Supp. 103 (S.D.N.Y. 1977).

[377] *Id.* at 107.

[378] Arguments for reformation are strongest in cases where the liquidated damages clause was an issue of negotiations. Contractual intent is clearest, using Llewellynian nomenclature, when there is specific assent to a term as compared with blanket assent to non-dickered terms. Professor Nimmer posed the question of how does one determine or define "dickered?" Raymond T. Nimmer, THE EMERGED AND EMERGING NEW UNIFORM COMMERCIAL CODE (ALI-ABA ed., 1999). The answer is that the Uniform Commercial Code, including the most recent draft of the Revised Article 2, recognizes the concept of the dickered term in its coverage of standard form contracting. That analysis can be used to determine if a liquidated damages clause was a product of dickering. If that analysis provides evidence that the parties intended to liquidate damages, then they should be allowed input into the reformation of the clause.

[379] The use of custom or trade usage to quantify reasonableness was noted by the court in *Bigda v. Fischbach Corp.* when it stated that one of the factors to be looked at in reviewing such a clause is whether "similar damages provisions were incorporated into other employment contracts." 849 F. Supp. 895, 902 (S.D.N.Y. 1994).

[380] *Supra* notes 44-51, 55, & 59 and accompanying text; *see also infra* section V.D.

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D. *English Law Commission Proposal*

In 1993, a *Contract Code* (the Code)[381] was published under the auspices of the English Law Commission. The Code recommended a number of revisions to the English law of liquidated damages. A review of its provisions is offered here as further evidence that the law in this area is in need of revision. Sections 444-446[382] set out a framework for the enforcement of liquidated damages clauses. Section 444 establishes a strong presumption in favor of enforceability. It states that "where parties to a contract agree in

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[381] HENRY MCGREGOR, CONTRACT CODE: DRAWN UP ON BEHALF OF THE ENGLISH LAW COMMISSION (1993).

[382] *Id.* at 132-38. The relevant provisions read as follows:

444. Damages Agreed in Advance Generally Recoverable

Where the parties to a contract agree in advance that a stipulated sum shall be payable on a breach of contract, then, subject to the provisions of sections 445 and 446, the stipulated sum is recoverable on breach, without proof of loss and irrespective of the amount of the provable loss.

445. Agreed Damages Greater Than Loss

If the party in breach proves the stipulated sum is not only greater than but also manifestly disproportionate to the amount which could be recovered by the other party in the absence of a stipulated sum, then

(a) if the court is satisfied that in all the circumstances (which in this section are taken to include the circumstances at the time of contracting, breach and trial, and in particular to include any relevant commercial or trade practice and customs) it is reasonable for the stipulated sum to be recovered, the court shall award the stipulated sum;

(b) if the court is satisfied that in the circumstances at the time of contracting it was reasonable for the parties to agree that the stipulated sum should be payable on breach but that in all circumstances it would be unreasonable for the whole stipulated sum to be recovered, the court shall substitute and award any lesser sum that it considers reasonable, even if the sum awarded would not have been recoverable under the general law relating to damages.

(c) otherwise the court shall award damages in the ordinary way as if there had been no agreement for the payment of a stipulated sum.

446. Agreed Damages Less Than Loss

If the stipulated sum proves to be less than the amount which could be recovered in the absence of a stipulated sum, the court shall nevertheless award the stipulated sum unless:

(a) the limitation of recovery to the stipulated sum has been expressly prohibited by statute or is held to be unreasonable.

(b) The claimant proves that the stipulated sum was intended to represent only the minimum amount recoverable.

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advance that a stipulated sum shall be payable on a breach of contract, then . . . the stipulated sum is recoverable on breach, without proof of loss and *irrespective of the amount of the provable loss*."[383] Thus, the comparison of the stipulated sum with actual losses is diminished in importance. Sections 445 and 446 make clear that proof of actual damages different than the stipulated sum is only one factor to be weighed by the courts. Sections 445 and 446[384] provide separate guidance for instances of overliquidation and underliquidation. Section 445 recognizes a *manifestly disproportionate* standard as the threshold for challenging a clause due to overliquidation. However, it also suggests that a manifestly disproportionate overliquidated damages clause may still be enforceable in some situations. The reasonableness determination is to take into account all circumstances existing at the time of contracting, at breach, and at trial. The circumstances shall include "any relevant commercial or trade practices and customs."[385] Section 445 seems to implicitly recognize the concept of *reasonable penalties*. If custom and trade usage indicate that penalties are appropriate in certain situations, then they should be enforced.

Section 445(b) couples the *intentions standard* with the remedial response of reformation. If it was reasonable for the parties to have agreed to the stipulated sum at the time of contracting, when in fact they agreed to an unreasonable amount, then the courts are authorized to reform the clause. If the parties negotiated an express liquidated damages clause, then their intentions provide the linchpin for a finding that it was reasonable for them to agree to the stipulated

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[383] *Id.* at 132.

[384] Section 446 confronts the issue of underliquidated clauses. It recognizes that underliquidated damages clauses are little more than limitation of liability clauses. "[A] small stipulated sum differs from the ordinary limitation of liability clause only in that it does not represent a ceiling beyond which recoverable damages cannot rise but forms the exact amount." *Id.* at 138. It defers to Section 108 of the Code (Limits Upon Contracting Out). *Id.* at 44; *see also Unfair Contract Terms Act 1977*, *in* BLACKSTONE'S STATUTES ON COMMERCIAL AND CONSUMER LAW 220 (4th ed. 1995) (generally holding that exemption or exculpatory clauses in consumer contracts are unenforceable). Section 447 deals with "alternative performance" clauses. These clauses have been used to avoid the law of liquidated damages. They provide the performing party alternative modes of performance, one being the payment of a stipulated sum. The Code simply states that such clauses are to be construed as liquidated damages clauses.

[385] MCGREGOR, *supra* note 381, § 445(a) at 133.

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amount. Reformation is recognized as the preferred remedial response when the parties reasonably intended to agree to liquidated damages, albeit fixing an unreasonable amount. Section 445(b) states that "the court shall substitute and award any lesser sum that it considers reasonable, *even if the sum awarded would not have been recoverable under the general law relating to damages.*"[386] Thus, the Code expressly rejects the idea that reformation will lead to the awarding of actual damages. One rationale offered in the commentary is that a finding of an amount of actual damages would not be required. "Accordingly, the court would be entitled to assess a figure *without strict proof.*"[387] This lowering of the threshold of proof serves to bolster one of the purposes for liquidated damages clauses—the avoidance of the need to litigate actual damages. Also, the lowering of the threshold of proof may be an implicit recognition of the argument that common law damages are undercompensatory and inefficient. The discounting of the need to compare actual damages to the stipulated sum allows for the fixing of the latter at an amount above the compensatory amount recognized under the law. In essence, a court is allowed to adjust the stipulated amount to take into account the undercompensatory nature of common law contract damages.

As discussed in the preceding paragraph, the reformation option lessens the need to provide strict proof. This lesser standard of proof also has implications for a party challenging a stipulated sum as manifestly excessive. The lowering of the threshold of proof allows two avenues to prove manifest excessiveness. First, the challenging party may use the common *disproportionality test* to prove a divergence between actual damages and the stipulated sum. Second, a challenging party may be able to show excessiveness by simply resorting to industry usage or custom. Either way, the need to prove actual damages is lessened, since the amount awarded by way of reformation may be an amount above or below actual damages.

The English Law Commission's *Contract Code* goes a long way in dismantling the law of liquidated damages. It maintains the appearance that the rule against penalties will continue to provide the means for a heightened review of liquidated damages clauses.

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[386] *Id.* § 445(b), at 133 (emphasis added). Notes to this paragraph indicate that the approach of the civil law is preferred. "[I]n the civil law, the court is generally given the power to modify the sum to a figure of its own choosing." *Id.* at 137.

[387] *Id.* (emphasis added).

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However, it fundamentally changes the law as currently constituted by lessening the proof requirements, recognizing trade usage and custom as probative evidence of reasonableness, and allowing for stipulated sums that would not have been *recoverable under the general law relating to damages*. Finally, its embracing of reformation as a preferred response aligns liquidated damages clauses with the law's review of contract clauses in general; namely, unconscionable clauses will be stricken or reformed.

VI. Conclusion

The task of justifying the non-enforcementful of bargained-for liquidated damages or penalty clauses remains unfulfilled. The legal and economic rationales given for the persistence of this contract limiting doctrine are ambiguous at best. The fact that other foreign legal systems recognize the enforceability of penalty clauses illustrates that the common law rule against penalties, as codified in Section 2-718 of the Uniform Commercial Code, is not an inevitable feature of advanced contract law regimes. Liquidated damages clauses should benefit from a strong presumption of enforceability, like any other contract term. They should only be voided upon the finding of unconscionability. A *basis of the bargain* approach should be utilized to preserve the sanctity of these clauses. If it can be proved that the parties fully negotiated the clause, then the clause should be enforced. Factors such as the lack of sophistication of one of the parties or the use of a standard form contract can be shown to overcome the presumption of enforceability. In cases of less than *full negotiation*, when the parties nonetheless intended to liquidate their damages, reformation should be the preferred response. It is for these reasons that the Revised Article Two of the Code should eliminate its section pertaining to liquidated damages clauses.

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