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PENALTY CLAUSES AND LIQUIDATED DAMAGES

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Abstract

This chapter surveys the economic literature on stipulated damages. In the literature there seems to be a consensus that liquidated and underliquidated damages should be respected. Liquidated damages can be a rational option, especially if parties have more information about the possible losses than judges. Underliquidated damages may serve as a technique to let parties share the risk of increased production costs.

Penalty clauses, on the other hand, have been the subject of a fierce controversy for a long time. Most authors seem to defend the prohibition of penalty clauses. Yet it can be argued that they should be allowed under some conditions.

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1. Introduction

Sometimes parties to a contract *ex ante* agree upon how much compensation will have to be paid should one of them breach the contract. These stipulated damages are called 'liquidated damages' when they are *ex ante* reasonable estimations of the true losses. They are called 'underliquidated damages' when they are meant to be undercompensatory and 'penalty clauses' when they are deliberately overcompensatory in order to create an additional sanction ('penalty'). In common law penalty clauses are forbidden according to the 'penalty doctrine'. Liquidated and underliquidated damages on the other hand are allowed.

This regulation of penalty clauses has received so much attention in the law and economics literature that it deserves a separate section. The first analyses did indeed not make clear why common law restricts the freedom of

contracting parties in this way. In 1979 Posner (1979, p. 290) described the penalty doctrine as ‘a major unexplained puzzle in the economic theory of law’. The penalty doctrine seemed to form an important exception to Posner’s general thesis that common law is efficient.

Before starting to review the literature it might be helpful to pay attention to the precise definition of the borderlines between penalty clauses and liquidated damages.

Rea (1984a) has argued that much of the confusion around the penalty doctrine occurs because of the failure to distinguish *ex ante* and *ex post* valuation of losses. It is not because stipulated damages *ex post* turn out to be overcompensatory that they will be considered penalty clauses by American courts. American courts only check whether the clauses are reasonable *ex ante*. When clauses are *ex ante* reasonable estimations of the true losses, or to put it differently, when clauses reflect the expected losses, they will be enforced.

In addition, liquidated damages are meant to compensate fully for losses, including subjective and other hard to prove losses. It is possible that courts mistakenly consider liquidated damages to be penalty clauses because they underestimate subjective costs. Yet, from an analytical point of view these clauses should be seen as liquidated damages. An early article of Goetz and Scott (1977) can serve as an illustration of this confusion. Goetz and Scott argued that a penalty clause is often just a way for a contracting party to insure itself against idiosyncratic harm or otherwise uncompensated damages. They give the example of a group of alumni who attach an enormous subjective value to attending a baseball game of their college team. Therefore, they stipulate in the contract with the bus driver that the latter will have to pay a high amount of damages in case he arrives late. This amount is high but just reflects their true subjective losses. Moreover, the promisor will very often be a better insurer than a traditional third party insurer. This argument, however, is in fact just a plea for respecting liquidated damage clauses and not necessarily an argument for supracompensatory penalty clauses.

2. Liquidated Damages, Penalty Clauses and Underliquidated Damages as Compared to Other Remedies

Many arguments for or against penalty clauses hold for other, less contested remedies as well. Therefore, it is important to situate these sanctions within the complete set of contract remedies, including the reliance measure, the expectation measure and specific performance.

At first sight, liquidated damages seem to be equivalent to the expectation measure. Liquidated damages are meant to fully compensate the promisee and 'fully' includes the expected profits (only in cases where the expected profits are compensated, the promisee is really indifferent with regard to performance or breach). The major difference seems to lie in the fact that liquidated damages are calculated *ex ante* (at the time of contracting) while the expectation damages are calculated or made operational *ex post* (after breaching). One major disadvantage of expectation damages is that they discourage efficient entering into contracts (see Chapter 4600), which holds for liquidated damages as well. To put it differently, if sellers demand liquidated damages in case of breach, fewer buyers than optimal will sign the contract.

With respect to breaching decisions, however, there is a difference. The expectation measure leads to efficient breaching (Birmingham, 1970; Shavell, 1980). Liquidated damages, however, are determined *ex ante*, so at the time the promisor decides whether to breach or to perform, he may already know that the stipulated damages are over- or undercompensatory. If they are overcompensatory, the promisor might overperform; if they are undercompensatory, the promisor might overbreach. This difference may be smaller than it seems. Judges do not compensate perfectly under the expectation measure either. If the promisor expects the judge to overcompensate he will overperform. If the promisor expects the judge to undercompensate he will overbreach.

To summarize, liquidated damages may create incentives to overperforming as well as to overbreaching. Whether incentives are worse than under the expectation measure depends on how well judges value the losses. If judges systematically and seriously undercompensate, then liquidated damages may be the superior remedy when it comes to incentives to breaching.

Penalty clauses and specific performance have in common that both are supracompensatory sanctions. One consequence is that both lead to overperformance, or to put it differently, that both discourage efficient breaches. Penalty clauses, however, award an amount of money to the promisee, while specific performance makes the promisor perform *in natura*. At first sight this leads to an important difference: only penalty clauses create an incentive for the promisee to induce breach. But much depends on how specific performance works in practice. Under American law, non-performing promisors have to pay a fine on the basis of 'contempt of court'. This fine is paid to the court so it does not alter the incentives of the promisee. But in France, Belgium and the Netherlands, specific performance is obtained by 'astreintes', high amounts of money (usually for each day of

non-performance), determined by a judge but to be paid to the promisee. *Astreintes* create incentives to induce the other party's breach as well.

An important difference between penalty clauses and specific performance lies in the temporal dimension (De Geest, 1994); for a more general discussion of the temporal dimensions of liability rules and property rules see Levmore, 1997).

Specific performance needs some time before it becomes operational. It works only for the future and not for the past. If by the time the promisee goes to court performance *in natura* is no longer possible (or no longer desirable), then courts will award just damages. Suppose someone had promised to deliver a wedding cake at the promisee's wedding, but did not show up. Specific performance makes no sense afterwards, so awarding damages is all the courts can do. On the other hand, penalty clauses can be awarded for breaches in the past. This means that a specific performance regime might in the real world be compensatory and that parties wanting extracompensatory sanctions may have no choice but to include penalty clauses in their contracts.

Finally, underliquidated damages can be the equivalent of anything in-between a perfectly applied expectation measure and no damages at all. They may be the equivalent of reliance damages but also of an undercompensatory expectation measure. Just as in the case of the reliance measure they lead to overbreaching. The problem of undercontracting will be smaller than under the expectation measure or even nonexistent, if they are set just to compensate reliance damages.

A. Liquidated Damages

3. Liquidated Damages Avoid *Ex Post* Valuation Difficulties

With liquidated damages losses are estimated *ex ante*, at the time of contracting. Such clauses avoid that judges have to compute the damages *ex post*. It is well known that judges may have serious difficulties in finding out the true losses. This holds especially for subjective harm. It is impossible for a judge to know the promisee's preferences precisely. Nor can he rely on what the promisee tells him, because the latter has no incentive to reveal his preferences in an honest way. This kind of preference revelation problem does not arise when the loss is determined *ex ante*. At that time the parties are still free to enter the contract or not. The higher the amount stipulated, the higher the price: the debtor will require compensation for his additional prevention costs and for the additional risk he has to insure. An *ex ante*

estimation is also useful for other forms of damage which are difficult to prove. The costs of forgone chances are one example. Lacking clear evidence, courts will underestimate such losses.

In this respect, liquidated damages reduce the risk of legal error. The probability that a judge will err in estimating the damage is largely eliminated. Of course the danger that a judge will erroneously consider the clause to be a forbidden penalty clause still exists. The risk that a judge wrongly applies the liquidated damage clause even though the debtor did not breach the contract, also remains.

A somewhat related advantage of liquidated damage clauses is that they allow us to avoid adverse selection problems. These problems arise when the seller does not know how high the losses of the buyer will be in case of breach. Because of this lack of information, the seller will assume *ex ante* that the potential promisee represents an average risk. The doctrine of foreseeability (*Hadley v. Baxendale*) serves to mitigate the adverse selection problems. It forces people whose damage may be higher than usual to communicate this to the seller. A liquidated damage clause can perform this function as well. However one crucial condition is that the liquidated damage clause is tailor-made. If liquidated damages do not take into account the individual characteristics of the buyer, but consist of standard term clauses, they no longer have this function.

4. Liquidated Damages Create Incentives for Optimal Reliance and Optimal Precaution

Cooter (1985) proved that damage clauses create a 'double responsibility at the margin'. First, the promisor receives an incentive to make an optimal amount of precaution costs. Second, the promisee gets a perfect incentive not to make too many reliance costs, because he will receive a fixed compensation in case of a breach of contract, regardless of the amount of reliance costs he has effectively incurred. This is not the case with normal expectation or reliance damages awarded by a judge, because judges generally do not examine whether the reliance costs made by the promisee were excessive or not. To be sure, the same result could be reached with damages that are judicially determined by compensating only for the efficient reliance costs. In practice, however, insuperable difficulties of proof often arise, which hamper the application of this remedy.

5. Liquidated Damages Substantially Increase *Ex Ante* Transaction Costs

To estimate the losses *ex ante* is nearly always more expensive than *ex post*. *Ex ante*, damages have to be estimated under all circumstances, even if *ex post* no loss is incurred. All states of the world have to be taken into account, while an *ex post* determination requires only information about the one situation that has really occurred. Finally, *ex post* there is usually more information on what really happened than *ex ante*. To put it differently, the *ex ante* information costs are higher because what will happen is still remote.

6. *Ex Post* Undercompensatory Liquidated Damages Lead to Inefficient Breaches, *Ex Post* Overcompensatory Liquidated Damages to Inefficient Performance

Liquidated damage clauses aim at correctly compensating the promisee's loss. However they are set *ex ante*, when full information may not be available yet. If *ex post* the compensation turns out to be clearly lower than the real damage, incentive problems arise, as briefly explained in Section 2.

If *ex post* the compensation turns out to exceed the actual loss clearly, the promisee will have an incentive to head for an inefficient breach of contract. The promisor will not breach the contract, even if it is efficient to do so. In case of a breach of contract, the promisee is overinsured; the contract thus contains a gambling clause. In return for this the creditor has had to pay a premium.

Other aspects may outweigh this disadvantage. A liquidated damage clause contains information on the possible magnitude of the loss. This information is useful for the promisor who has to decide whether a breach of contract is efficient or not. Because this information is produced in advance, the promisor may make more efficient decisions. The promisor will also be able to decide more quickly whether the good has to be sold to a third party. For the same reason, a liquidated damage clause can also lead to a more optimal level of prevention costs. If the loss or the possible loss is lower than what the debtor would normally expect, it is also desirable that he makes fewer prevention costs than usual. The opposite holds when the damage is higher than usual.

B. Penalty Clauses

7. The Rationality Argument and the Signing Without Reading Problem

One earlier argument against the penalty doctrine was directly derived from the rationality assumption in economics: we may assume that people are rational, so if they sign a penalty clause they must have good reasons to do so. The contract must be efficient, otherwise they would not have signed it. This argument is implicitly used in the very first economic paper on the subject (Barton, 1972, p. 286). Barton argued that all liquidated damage clauses should be enforced without distinction, at least when the provision was knowledgeably and fairly bargained-for.

The rationality argument is more explicit in Kronman and Posner (1979). Criticizing Clarkson, Miller and Muris (1978) they argue that if penalty clauses would really create an incentive for the promisee to induce the promisor to breach, this danger would be reflected in the parties' negotiations over the contract price or other terms of the contract. If the penalty clause survives the negotiation process, this is presumably because the benefits to the promisee exceed the costs to the promisor. According to Kronman and Posner (1979) there may be room for intervention if one thinks that the parties cannot assess these costs correctly, but then the basis for intervention is paternalism. As a limitation on the freedom to contract, the penalty doctrine is more paternalistic than the contractual incapacity of minors or the invalidity of contracts of self-enslavement. A somewhat similar idea can be found in Farber (1983) who argued that in addition to contract law (the principle of freedom of contract) seems to embody a kind of safety belt against individual catastrophic losses (including losses resulting from penalty clauses).

Ulen (1984, p. 356) used the rationality assumption to defend penalty clauses very explicitly '*there is every reason to believe that they will stipulate the most efficient remedy, considering all the factors*'.

This argument, however, is not very convincing. Even though economic science is based on the assumption of rational behavior, the existence of information problems is generally accepted. 'Rational' does not mean perfectly informed.

It cannot be denied that allowing penalty clauses implies an important danger: signing without reading (Mackaay, 1982; De Geest, 1994). Contracting parties do not always read or understand what they are signing. The party drafting the contract may speculate on this and include certain clauses which would never have been accepted if they had been read. It must be clear that this problem is not merely theoretical: penalty clauses may ruin one's business and make others rich.

The signing without reading problem is elaborated by Mackaay (1982). Contract terms are in general more costly to verify than most physical features of commodities. Since most consumers will not inspect the terms, the market may adapt 'harsh-term-low-price' policies. In order to counter this perversity, some form of government intervention may be desirable.

Of course it would be undesirable to solve the signing-without-reading problem by declaring all signed contracts void.

A better strategy is therefore to prove that under certain circumstances some clauses will never be signed by rational, well-informed parties. The fact that some people in the real world do sign such clauses can then be considered as evidence that there was a serious procedural deficiency in the formation of the contract (for a good example of this strategy see Rea, 1984a).

8. The Costs of Legal Error are Higher for Penalty Clauses than for Liquidated Damages

Accepting a penalty clause is always a bit risky, even for those promisors who perform exactly as promised. There is always a chance that a judge will erroneously enforce a penalty clause, due to either a mistake or difficulties of proof. A promisor who behaves optimally but cannot prove, for example, that there was force majeure, could wrongly be sentenced to pay an enormous amount. The risk of legal error is very hard to insure.

A comparison can be drawn with criminal law. If the judicial system worked perfectly and if everybody behaved rationally, punishments could be infinitely harsh. After all, a rational person would never commit a crime and therefore nobody would be erroneously convicted. But just because the judicial system works imperfectly, sanctions should not be infinitely harsh. The same holds for sanctions for breach of contract.

9. Penalty Clauses Discourage Efficient Breaching

In the second edition of his textbook, Posner (1977, p. 93) suggested that the law may refuse to enforce penalty clauses because they give an incentive to complete the contract, even when breaching would be efficient. This argument is correct, but should be put in context, as argued in Section 2. All extracompensatory sanctions have this disadvantage. This applies to specific performance, to liquidated damages that *ex post* turn out to be overcompensatory, and to the expectation measure if judges systematically overcompensate the promisees.

10. Penalty Clauses give Promisees an Incentive to Induce Breach of Contract

This was first elaborated by Clarkson, Miller and Muris (1978). Suppose I sign a contract with a builder. If the builder fails to perform in time, my true losses are \$1,000, but a penalty clause will award me \$1,001,000. So I hope the promisor will breach the contract and I will even do whatever I can to make the promisor miss the deadline. However in many cases I will not have any opportunity to mislead or hinder the debtor. Even if I have the opportunity I must be able to do it covertly, because if the debtor can prove that I am responsible for the breach, I will get no compensation. Covenants not to compete, and clauses where the sole relation between the parties is that of borrower and lender are a few examples given by Clarkson, Miller and Muris (1978) where inducement of breach is no danger. But where covertly induced breaching is possible, penalty clauses should be forbidden. For a similar argument, see X (1978).

In a student note (X, 1978) the thesis that preagreed damage clauses should be reasonable in the light of actual harm is defended too. This test enables full compensation of the non-breaching party to occur since the preagreed damage clause will be enforced as long as the breaching party is unable to show that actual damages are less than the sum of objective and subjective damages. In addition, the *ex post* test is consistent with the discouragement of wagering and breach-inducing activities.

Theoretically, the argument is correct. Yet it applies to all other supracompensatory sanctions as well. As argued in Section 2, there is a similar problem when specific performance is made operational through the use of 'astreintes'. The major question is in how many cases the promisee has an opportunity to covertly induce breach. It is not so easy to make a debtor fail when he is aware of the dramatic consequences of his breach. However a technique (not considered by Clarkson, Miller and Muris, 1978) that has more chances to succeed is to let a promisor sign a contract that he did not read.

11. Do Penalty Clauses Lead to More Trials?

Landes and Posner (1979) mentioned that historically the penalty doctrine was created at a time when judges were paid from litigation fees. As argued by Rea (1984a) this argument does not explain why the penalty doctrine persisted in an era of subsidized courts.

Rubin (1981) built on the theory of self-enforcing contracts introduced by Telser (1980) and argued that penalty clauses are not self-enforcing; they can be enforced only by court intervention. Every breach of contract by the

debtor will therefore lead to a trial. The costs of these trials are not fully borne by the parties themselves. Courts are largely subsidized. Because some costs are externalized, parties will stipulate penalty clauses more often than is optimal. Rea (1984a) remarked, however, that this argument could be used in many more cases. There are numerous areas in which courts seem to encourage the use of judicial resources, even though they are supplied at little cost. Furthermore, the additional uncertainty associated with the unenforceability of penalty clauses might increase litigation too.

The reasoning of Rubin (1981) is implicitly contradicted by the modern economic literature on settlement versus trial (see Chapters 7000 and 7400). In principle rational parties do not go to court. They prefer a settlement rather than an expensive trial. Why would a rational debtor refuse to pay the damages stipulated in the contract spontaneously if these clauses are valid in that legal system? It would cost him a lot more if the promisee went to court. A trial between two rational parties is only possible if they have different perceptions of their chances to win. This will happen more often if it is hard to predict the decision of the judge. With a legal rule allowing all penalty clauses, the probability of different perceptions will be reduced to nearly zero. The judge will certainly declare the penalty clause valid. Discussions, on the other hand, may arise if penalty clauses are forbidden while liquidated damage clauses are allowed, or when such clauses are forbidden if they exceed the highest damage possible. In those cases the judge has to draw a line and where that line lies is not always clear. Whether this is a valid argument against regulations prohibiting (certain) penalty clauses, is doubtful, however. The problem of the excessive subsidization of courts can be solved more easily by increasing the trial costs.

12. Penalty Clauses as a Barrier to Entry?

In the literature it has been argued that penalty clauses entail another serious potential danger: their use as a barrier to entry.

Diamond and Maskin (1979) are the first to clearly demonstrate the external effects of damages. In their model, individuals search for partners and negotiate contracts to produce output. The individuals may decide to breach their contract and form a new partnership. Since the surplus of this new partnership depends on the damages that a breaching party has to pay to its old partner, they also affect its new partner. By stipulating liquidated damages parties to a contract can therefore exert some monopoly power over potential partners.

By illustrating how liquidated damage clauses can reduce competition Aghion and Bolton (1987) again stress the external effects of such clauses.

In their model an incumbent seller and a buyer can sign a contract specifying a price and liquidated damages in case the buyer breaches the contract. In line with Diamond and Maskin (1979) it is shown that this contract gives the parties some joint monopoly power over a potential competitor. The buyer will not breach the contract and trade with a new entrant unless the latter compensates him for the liquidated damages that he owes to the incumbent seller. The liquidated damages thus act as an entry fee which enables the contracting parties to appropriate part of the surplus of a more efficient producer who enters the market. Because of this entry fee a welfare-enhancing entry is blocked and the contract introduces a social cost.

Chung (1992) analyzes the effects of the penalty doctrine in a framework similar to that of Aghion and Bolton (1987). But in his model the buyer also has to make a reliance decision and the third party is a new buyer with a higher valuation for the good. He shows again that by stipulating in the initial contract a high level of liquidated damages, the parties to a contract could raise the price that a third party has to pay to induce a breach of contract. However, when the reliance investment of the buyer is fixed, the penalty doctrine, by putting an upper limit on the enforceable stipulated damages, eliminates this inefficiency and allows the implementation of the first-best outcome. This no longer holds when the reliance investment of the buyer is variable. Then the promisee will overrely on it, even with the penalty doctrine in place.

In the literature, the Aghion and Bolton model is often used as an argument against penalty clauses. However, this barrier-to-entry-argument applies to the expectation measure and to liquidated damages as well.

Consider a contract for the duration of 10 years that binds all consumers in a market to a monopolistic seller. The production costs of the current monopolist are 50 and the price is 100. The sanction for breach is the expectation measure (the standard remedy under both Anglo-American and continental law), which means that a breaching buyer has to pay 50. A new entrant with a production cost of 50 offers the same product at a price of 51. None of the buyers will breach. If the product is sold at production costs, that is 50, consumers are indifferent. But if we assume that changing partners always involves positive transaction costs (a very plausible assumption), the new entrant will still not attract any of the existing consumers. So the expectation measure, which is the normal sanction for breach in Anglo-American law, as well as in continental law, can serve as a barrier to entry as well.

Aghion and Bolton (1987) merely view their paper as an illustration of the much broader problem of the endogenous creation of switching costs. Other examples include advance deposits in rental contracts, frequent flyer programs, trading stamps, deferred rebates by shipping firms, fixed fees in

franchise contracts and so on. Even if the penalty doctrine is needed to counter the use of damage clauses as a barrier to entry, it will not necessarily capture other contract clauses which may have the same effect. Given the variety and complexity of potential contract clauses, antitrust authorities face an almost impossible task here.

13. Can Penalty Clauses Have a Signalling Function?

The idea that penalty clauses can be useful as a signal for a promisor's reliability was first articulated by Posner (1977, p. 93). According to Posner, this signalling function is important especially for new entrants in the market who have not yet built up a reputation. An effective way for a promisor to convince other parties that he will perform as promised is to offer a penalty clause against himself. The fact that the promisor is willing to offer such a heavy sanction on his non-performance signals that he is convinced that he is willing and able to perform. Thus a penalty clause has a communicative function: it is a signal of reliability sent by the debtor. Although this idea has been seriously criticized in the literature, Posner retains this argument in the third and the fourth editions of his handbook (Posner, 1986, 1992).

Apparently, this argument was countered in a convincing way by Muris (1981) and Rea (1984a). According to those authors a liquidated damage clause can perform this function equally well. A liquidated damage clause fully compensates the promisee, making him indifferent as to whether the promisor will breach or perform. So if a new entrant promises to fully compensate the losses in case of non-performance, potential parties are satisfied too. But compared to penalty clauses, liquidated damages entail fewer incentive problems. This may be reflected in a lower price of the product or service. A similar argument was developed by Schwartz (1990).

De Geest (1994), however, has argued that under some conditions, the signalling theory becomes defensible. It is cheaper to draft a penalty clause than a liquidated damage clause. In the case of a liquidated damage clause one has to form an idea of all possible damage cases that might occur and to compute an average of them. For a penalty clause it suffices to estimate the highest possible damage.

A penalty clause may therefore be desirable when a precise liquidated damage clause is too costly and the courts systematically award a compensation which is too small or which is exact on average but uncertain.

A debtor may, for instance, want to use a standard form contract with a penalty clause to his own detriment. It may be too costly to draft a liquidated damages clause for every person individually. Therefore a standard form contract is used with a penalty clause compensating for the highest loss

possible. For most creditors the compensation exceeds the real damage and even the *ex ante* estimation of it. Therefore, one clearly has to do with a penalty clause.

If the loss of the average creditor is taken as a starting point, an adverse selection problem would therefore arise in such cases. The creditors with the highest real damage would not contract. On the other hand no high premium has to be demanded in return for the penalty clause when the only risk consists of non-performance by the debtor. For a bona fide debtor this risk is almost equal to zero, leaving aside the legal error costs.

However, this signalling argument can never justify a penalty clause that applies to force majeure cases (De Geest, 1994). Such a penalty clause that applies in case of force majeure is an instance of overinsurance, a gambling clause. The suggestion of Posner (1973) that courts are taking a stand against gambling contracts makes sense in that respect.

14. Penalty Clauses as Punitive Sanctions when the Apprehension Rate is Lower than 1

In the economic literature on tort law it is generally accepted that punitive damages may be economically desirable when the injurer has a significant chance of escaping liability for the harm he caused (Polinsky and Shavell, 1998).

While apprehension rates are generally higher in contract than in tort cases, there may be contract cases where it is difficult to discover or prove the debtor's breach. It has been argued that punitive damages should be awarded in those cases (Perlstein, 1992; Polinsky and Shavell, 1998, pp. 936-939). See also Farber (1980) and Schwartz (1990) for a discussion of the economic function of punitive damages in breach of contract disputes.

Penalty clauses may remedy this problem as well. Their extra-compensatory nature compensates apprehension rates lower than 1. Which of both remedies is the best - punitive damages or penalty clauses - is still a relatively unexplored issue. Punitive damages have one comparative advantage: the apprehension rate can be calculated more realistically, because it is determined *ex post*, when more information about what happened is available. But this *ex ante* lack-of-information argument is a more general one that can be used against liquidated damages as well (*ex ante* it is more difficult to predict the magnitude of the harm than *ex post*). It may therefore be insufficient in itself to justify the penalty doctrine.

15. Penalty Clauses as a Technique to Obtain Backward-Looking Specific Performance

In Section 2 we have already discussed an important difference between penalty clauses and the specific performance remedy. Specific performance only works for the future and not for the past. If performance in natura is no longer desirable, courts will award just damages. On the other hand, penalty clauses can be awarded for breaches in the past. This means that the traditional specific performance remedy may sometimes not be enough of a disadvantage to make the promisor perform specifically. Penalty clauses may therefore be the only technique to really guarantee specific performance.

16. Penalty Clauses as a Technique to Create Risk Sharing

Polinsky (1983) demonstrated that stipulated damages, which differ from expectation damages, can be necessary to obtain an optimal risk allocation. Under some conditions, penalty clauses can be a technique to let parties share the risk of a higher third party bid.

Consider a contract to sell a Van Gogh painting. The price is 100 but the buyer's true valuation is 150. There is a chance that before the date of delivery a third party will arrive offering 200. Suppose that the parties want to share that risk equally. This result can be obtained by stipulating in the contract that the seller should pay damages amounting to 75 in case of a breach. Should there be a third party offer, then the seller will indeed breach and make an additional profit of 25 (a price increase of 100 minus 75 damages). The buyer will be 25 better off as well. Yet the damages of 75 are overcompensatory (at least if the buyer had no sufficient knowledge of the market to have found the third party himself).

A penalty clause exceeding 100 (in the latter example) allocates the risk entirely to the buyer. At first sight, penalty clauses are not necessary here, however, since the specific performance remedy obtains the same result. Yet, rational parties may prefer penalty clauses in those cases for the reasons discussed in the former section (specific performance cannot always restore breaches in the past). Of course, penalty clauses can be a good second-best solution when specific performance could clear the job as well but is not available in the legal system.

17. Do Penalty Clauses Increase the Number of Bankruptcies? Penalty Clauses to Sanction Debtors Financing their Commercial Activities via Delayed Payments

According to Farber (1983) penalty clauses lead to more bankruptcies. A debtor will have to pay a much higher amount in case he breaches and will therefore more easily get into financial distress. If the bankrupted party is involved in a web of long-term business relations with others, these too will be disrupted. If the other contracting parties fail to include penalty clauses in their own contracts, they will be disadvantaged when it comes to receiving a share of the assets in bankruptcy. If the use of penalty clauses were widespread, a wave of business failures triggered in a recession by penalty clauses could have a severe effect on investor confidence.

But Farber (1983) does not take into account another cause of insolvency, as argued by De Geest (1994). Entrepreneurs who are working with other people's capital sometimes take on excessive commercial risks. This danger is particularly serious when they finance their activities with fixed interest loans. Then the downward risk of the entrepreneurs is externalized while the upward risk is internalized. This is why shareholding is a more common way of raising money. Yet there is a subtle way to coerce non-assenting people to lend money at a fixed interest rate: let them work for you or deliver goods and simply delay paying them. The creditor can then go to court, but it may take a long time before he is able to enforce his rights. This problem is most pressing in case of corporations that are about to go bankrupt.

A penalty clause will not really prevent the entrepreneurs from taking on commercial risks. They can always turn to any owner of capital they may find. The latter will only lend out his money if he believes that he will benefit from it. In case of intrinsically loss-making projects this is almost impossible. A penalty clause in relation to an obligation to pay a sum of money just makes it more costly to force creditors to lend capital against their will. Penalty clauses will direct capital seeking entrepreneurs from non-specialized borrowers (painters, sellers, builders, ...) to specialized borrowers (bank, shareholders, ...). The result is economically desirable and may lead to a lower number of bankruptcies, or at least to lower drains in case of bankruptcy.

By the same token, a penalty clause may be efficient in the case of loans. A penalty clause that corresponds to the highest possible risk premium possible will create proper incentives for a debtor to borrow additional money from parties that explicitly give their consent.

C. Underliquidated Damages

18. Unliquidated Damages as a Technique to Create Risk Sharing

Probably, the most important function of underliquidated damages is to make risk sharing possible for production cost uncertainties.

In case of underliquidated damages against a producer, the risk of increased production costs is shared between the debtor and the creditor. The debtor only bears this risk to the extent of his own profit and a fraction of the consumer surplus of the creditor. The creditor bears the risk to the extent of the remaining part of his consumer surplus.

Underliquidated damages against a consumer are possible as well. They imply that a consumer who cancels a reservation or an order, does not have to compensate the total profit of the producer or the seller. The risk of decreased utility is shared between the creditor and the debtor. The creditor bears this risk to the extent of his own consumer surplus and only a fraction of the profit of the debtor. The debtor bears the risk to the extent of the remaining part of his profit. Underliquidated damages thus allow agreement on, for instance, the reliance measure, the default rule prescribing the expectation measure.

19. Other Advantages and Disadvantages of Underliquidated Damages

Underliquidated damages create a number of inefficient incentives. The creditor gets an incentive to avoid by all means an efficient breach of contract, because his compensation given a breach of contract is lower than his consumer surplus with specific performance. The debtor gets an incentive to head for an inefficient breach of contract in case of increased performance costs of the seller or decreased utility for the buyer. Underliquidated damages for the risk of a higher third party offer boil down to a gambling clause. With respect to the allocation of that risk, this is always undesirable unless the creditor is risk seeking.

But underliquidated damages resemble the reliance measure. Also, with the latter, the compensation is lower than the real (expectation) damage. Compared with expectation damages, reliance damages have one big advantage: they lead to an optimal level of contracting.

Because rational parties may have good reasons to stipulate underliquidated damages, it is not desirable to readjust this clause. That would be a type of regulation which does not necessarily improve the situation.

As shown by Stole (1992) underliquidated damages may also play a role as screening device. Standardized underliquidated damages can give high-value buyers an incentive to reveal their true valuations. We could compare this with the foreseeability doctrine in ordinary contract law: if parties do not use stipulated damages, courts will undercompensate the promisor if his losses were unforeseeable to the promisee (*Hadley v. Baxendale* in the common law). The economic function of that rule is to make promisees reveal in advance that they are more vulnerable.

D. Conclusions

20. Liquidated and Underliquidated Damages should be Allowed

In the literature there seems to be a consensus that liquidated and underliquidated damages should be respected. This means that judges should not test liquidated damages against the real *ex post* damage. If judges always corrected liquidated damages that turn out to differ from the real losses, this would mean that the *ex post* valuation of the judge is the only thing that ultimately counts (except for those cases where judges are uncertain as to what are the true losses and put the burden of proof with the party that argues that the true losses differ from what is stipulated *ex ante*).

Liquidated damages can be a rational option, especially if parties have more information about the possible losses than judges. Underliquidated damages may among other things be useful to let parties share the risk of increased production costs.

21. Under what Conditions should Penalty Clauses be Allowed?

Penalty clauses, on the other hand, have been the subject of a fierce controversy for a long time. Most of authors seems to defend the penalty doctrine - the common law doctrine that forbids penalty clauses. It cannot be denied that penalty clauses have many disadvantages. Yet they may have a number of functions as well.

Though penalty clauses should be forbidden in most cases, we nevertheless believe that they should be allowed under a few well-defined conditions.

(a) A penalty clause against the drafter of a standard term contract should be allowed when it reflects the highest possible losses. Consumers may indeed have varying losses in case of breach. Drafting a tailor-made liquidated damages clause for each consumer individually may simply be too

costly. The signing-without-reading problem is extremely unlikely to occur if the penalty clause is conceived against the drafter of the contract.

(b) A penalty clause for the obligation to pay an amount of money in time should be allowed. Here it is quite rational to set the interest rate so that it reflects the highest possible commercial risk. An interest rate of 200 percent a year may discourage bad-faith promisors to finance risky, commercial projects by retarding payment to non-consenting promisees. Of course there is still a signing-without-reading danger here. But this may be limited if the interest rate is not set at a nearly infinite level but at one that just reflects a very high commercial risk.

Yet in case of force majeure, these penalty clauses should not be enforceable even if conditions (a) and (b) are fulfilled. It is impossible for a penalty clause to have a signalling function here. This would be an instance of overinsurance, a gambling clause.

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