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David Brizzee

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Liquidated Damages and the Penalty Rule: A Reassessment

I. Introduction

In a contractual dispute between two parties, a liquidated damages provision in the contract will be struck down if the court believes that the amount to be paid is a penalty instead of a reasonable estimate of future damages resulting from a breach.

> Parties to a contract may stipulate in advance as liquidated damages an amount to be paid as compensation for loss or injury which may result in the event of a breach of the contract, and such stipulations are valid and enforceable. However, when a sum is stipulated in a contract as a *punishment* for default, . . . not as the measure of *compensation* for breach of the contract, the stipulation is a penalty and is invalid and nonenforceable.[1]

The Restatement position is similar to the A.L.R. annotation: "Damages for breach by either party may be liquidated in the agreement but only at an amount that is reasonable in light of the anticipated or actual loss caused by the breach . . . . A term fixing unreasonably large liquidated damages is unenforceable on grounds of public policy as a penalty."[2]

Three criteria distinguish valid liquidated damages provisions from invalid penalty provisions: (1) "the parties must intend to provide for damages rather than a penalty," (2) the injury must be "uncertain" or "difficult to quantify," and (3) the stipulated amount must be a "reasonable pre-estimate of the probable loss."[3]

The distinction between liquidated damages and the penalty rule has its roots in equity, where penalties agreed upon by

1. Annotation, *Contractual Provision for Per Diem Payments for Delay in Performance as One for Liquidated Damages or Penalty*, 12 A.L.R.4TH 891, 899 (1982) (emphasis added).
2. RESTATEMENT (SECOND) OF CONTRACTS § 356(1) (1981).
3. JOHN D. CALAMARI & JOSEPH M. PERILLO, CONTRACTS § 14-31, at 640-41 (3d ed. 1987).

the respective parties would not be enforced.[4] Courts of law gradually adopted this rule to prevent unconscionable bargains and over-reaching by one of the parties.[5] The rule has become firmly entrenched in American jurisprudence; the distinction between a valid liquidated damages clause and an invalid penalty clause has even been adopted in the U.C.C. and codified in state laws.[6]

However, the rule is anomalous, given the general feeling of most jurists that freely bargained contracts between parties on equal footing are valid, absent fraud, mistake, or duress. Furthermore, exhaustive studies and many commentators indicate that, at the very least, parties may desire the inclusion of penalty provisions for legitimate reasons and should be able to do so.[7]

In part II, this comment discusses some justifications that have not previously appeared in the literature for allowing penalty provisions in contracts. The comment also assembles justifications that have been proposed by other commentators. Part III discusses those justifications for eliminating penalty clauses.

II. JUSTIFICATIONS FOR ENFORCING PENALTY CLAUSES

A. *The Concept of Contractual Freedom*

Perhaps the most compelling reason for allowing a freely bargained penalty provision to remain in a contract is the con-

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4. *Id.*
5. *Id.*
6. *See* U.C.C. § 2-718(1) (1989).
7. *See* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 115-17 (3d ed. 1986); 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); Phillip R. Kaplan, Note, *A Critique of the Penalty Limitation on Liquidated Damages*, 50 S. CAL. L. REV. 1055 (1977). *But see* Kenneth W. Clarkson et al., *Liquidated Damages v. Penalties: Sense or Nonsense?*, 1978 WIS. L. REV. 351 (1978). *See generally* Samuel A. Rea, Jr., *Efficiency Implications of Penalties and Liquidated Damages*, 13 J. LEGAL STUD. 147 (1984); Alex Y. Seita, *Uncertainty and Contract Law*, 46 U. PITT. L. REV. 75, 102-19 (1984); Thomas S. Ulen, *The Efficiency of Specific Performance: Toward a Unified Theory of Contract Remedies*, 83 MICH. L. REV. 341, 349-56 (1984); Comment, *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); Susan V. Ferris, Note, *Liquidated Damages Recovery Under the Restatement (Second) of Contracts*, 67 CORNELL L. REV. 862 (1982).

cept of contractual freedom. Absent some type of unconscionable behavior such as duress, a contractual provision that has been freely bargained between two equal parties at arm's length generally benefits the bargaining participants as well as third parties. One party may receive proportionally more benefit than the other, yet both parties will, to some degree, benefit.

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. (Of course a party may miscalculate, but a certain amount of risk is inherent within any business proposition.)

Implicit in this understanding is the fact that each bargainer knows what is in her own best interest to include or exclude from the contract. Each party knows his own situation and the surrounding circumstances better than any third party such as a judge or arbiter. Each party with sufficient information has the ability to synthesize this knowledge and determine what is in his or her best interest.

Adam Smith made this clear when he stated that "every individual, it is evident, can, in his local situation, judge much better than any statesman or lawgiver can do for him."[8] Therefore, if both parties determine that a penalty clause should be inserted into the contract, they should be able to include such a provision. Society in general also benefits from this type of exchange.

> [Every individual generally] neither intends to promote the public interest, nor knows how much he is promoting it . . . . [H]e is in this [case], as in many other cases, led by an invisible hand to promote an end which was no part of his intention. Nor is it always the worse for the society that it was no part of it. By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it.[9]

By disregarding penalty provisions in contracts, courts misunderstand the results of bargaining undertaken by two independent parties. By adopting the penalty rule, courts evi-

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8. THE ESSENTIAL ADAM SMITH 265 (Robert L. Heilbroner ed., 1986).
9. *Id.*

dence an intent to spare the parties from the rough and tumble of the bargaining process. But courts have neither the resources nor the knowledge that are available to contracting parties to determine what is in the best interests of these parties.

The penalty rule is fraught with misconceptions about the bargaining that takes place between parties and also about the basic economics involved in bargaining. As a result, the goal of encouraging economic efficiency has been turned on its head and the absolute reverse is generally occurring—economic inefficiency is generally promoted by the rule. Prominent economists have noted:

> The key insight of Adam Smith's *Wealth of Nations* is misleadingly simple: if an exchange between two parties is voluntary, it will not take place unless both believe they will benefit from it. Most economic fallacies derive from the neglect of this simple insight, from the tendency to assume that there is a fixed pie, that one party can gain only at the expense of another.[10]

Instead of viewing the penalty provision in a contract as some type of punitive or coercive measure, a court should view the voluntary exchange that led to the penalty provision as beneficial to both parties. By allowing parties who would not have made the contract except for the penalty provision to reach agreement and proceed with a transaction, the process should not be viewed as the mere shifting of the pieces of a "fixed economic pie," but as wealth creation and expansion of the existing economic pie.

For instance, suppose *A* knows that she can perform her part of the contract adequately, but for some reason *B* has reason to fear that *A* will not perform.[11] *A* could offer to include a penalty clause in the contract that would convince *B* that she is capable of performing her contractual obligations. The penalty provision would act as a guarantee to *A*'s performing her contractual obligations. Otherwise a heavy price would be exacted for nonperformance. Therefore, the penalty provision conveys information about *A*'s determination to perform her contractual obligations. If courts do not enforce these types of

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10. MILTON FRIEDMAN & ROSE FRIEDMAN, FREE TO CHOOSE: A PERSONAL STATEMENT 5 (Avon Books 1981).
11. POSNER, *supra* note 7, at 116.

penalty provisions, then the parties are forced to "find a more expensive, less efficient way in which to exchange promises."[12]

Of course, a reasonable estimate of probable damages contained in a contract will be upheld. However, in the preceding example, *B* might not be convinced of *A*'s determination to perform unless something more than a reasonable estimate of damages is written into the contract. *A*, who intends to perform, is therefore hampered by her inability to include punitive damages in the contract.

B. The Penalty Rule Is Paternalistic

Striking down a penalty provision also demonstrates a court's paternalistic attitude. In effect, the court is saying that two relatively equal parties are not capable of defining their own contractual provisions and that the court "knows best"; indeed, the rule implies that parties need to be protected from their own decisions. Absent some type of coercion, the reality is that the parties would not have entered into the contract had it not been in their best interests to do so. The parties expect the gains to outweigh the costs.[13]

More philosophically, one commentator explains:

> All paternalistic restrictions on conduct, including those contained in the law of contracts, raise special problems from a moral point of view . . . . One who believes . . . that some paternalistic restrictions on contractual freedom are not only permissible but morally required, must supply a standard or principle for evaluating paternalistic arguments in particular cases; only in this way can the legitimacy of paternalism be established and its limits defined.[14]

Unfortunately, the courts have set no such standard for the paternalistic penalty rule in contracts. The liquidated damages clause is uniformly struck down if the court perceives it to be a penalty clause. For instance, if a new contractor in the construction business wants to include a penalty provision to convey her determination to perform the contract, courts will not examine the compelling circumstances but will strike down the

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12. ROBERT COOTER & THOMAS ULEN, LAW AND ECONOMICS 295 (1988).
13. POSNER, *supra* note 7, at 116.
14. Anthony T. Kronman, *Paternalism and the Law of Contracts*, 92 YALE L.J. 763, 764-65 (1983) (citations omitted).

offending clause. Because an adequate standard or principle is not given in this particular case, this is paternalistic.

Furthermore, when two sophisticated parties, such as large corporations, include a liquidated damages provision that is essentially a penalty, it is difficult to understand why a court should necessarily concern itself with the matter (assuming, as always, that the provision was freely bargained). "[I]t seems odd that courts should display parental solicitude for large corporations [by their refusal to enforce penalty clauses]."[15]

C. *Historical Reasons for Striking Down the Penalty Clause in Contracts Are Unpersuasive*

Historically, courts have been reluctant to allow penalty clauses in contracts for the following reasons: 1) the perception that a penalty clause discourages efficient breaches of contract by making breach more costly, 2) the inability of the market to adequately provide the information that parties need to balance contractual responsibilities,[16] and 3) the possibility of unequal bargaining positions between contracting parties. But as Goetz and Scott concluded, these historical reasons are no longer persuasive:

> In sum, contemporary cost-benefit analysis suggests that the traditional penalty rule is anachronistic for several reasons: (1) the [increased] efficiency costs of the rule [prohibiting penalty clauses] are now apparent in the light of modern analysis; (2) the market imperfections [lack of access to information with subsequent increased risk] once addressed by the rule have become empirically less important; and (3) more selective legal doctrines, such as unconscionability, have developed as remedies for those market imperfections which retain practical importance.[17]

Goetz and Scott argue that the penalty rule "has numerous costly effects" such as "the [judicial] review of the entire continuum of cases where liquidated damages provisions are intended to reimburse true losses which are to any extent uncertain."[18]

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15. Lake River Corp. v. Carborundum Co., 769 F.2d 1284, 1289 (7th Cir. 1985).
16. Goetz & Scott, *supra* note 7, at 555.
17. *Id.* at 594.
18. *Id.*

Moreover, the market failure that should be regulated is unfair bargaining, not the insertion of penalty clauses in contracts. The legal doctrine of unconscionability addresses this unfairness and is a less costly alternative than a blanket prohibition of penalty clauses.[19]

D. *Penalty Clauses Promote Efficiency in Contractual Relations*

1. *Penalty clauses promote efficiency by compensating for idiosyncratic harm*

Allowing penalty clauses permits compensation for idiosyncratic harms (unique harm that occurs to only one party and can only be measured by that party). This concept allows one party to obtain compensation for harms to subjective values.

> In sum, many people may not want to make deals unless they can shift to others the risk that they will suffer idiosyncratic harm or otherwise uncompensated damages. To the extent that the law altogether prevents such shifts from being made or reduces their number by unnecessarily high costs, it creates efficiency losses; that is, it prevents some welfare-increasing deals from being achieved.[20]

The difficulty of placing a value on idiosyncratic harm is made clear in *Carpel v. Saget Studios*.[21] In *Carpel*, a husband and wife sued a photographer who had contracted to take black and white pictures of their wedding. The pictures were never delivered and plaintiffs sought damages. The court ruled that

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19. *Id.*

20. *Id.* at 583. *But see* Clarkson et al., *supra* note 7, at 379 n.77. Clarkson et al., maintain that idiosyncratic values can be recovered even though penalty provisions are not enforced. The problem with this analysis is that idiosyncratic values, by their very nature, are difficult to quantify. *See infra* note 22 and accompanying text. Only the party who has the potential idiosyncratic harm knows what this amounts to. When the parties negotiate the penalty provision, the party with the idiosyncratic value will probably insist on a penalty that will equal his idiosyncratic harm in the event of breach. The other party, in a freely bargained exchange, will have the opportunity to accept or reject the penalty. This is much more efficient than having a third party, such as a court, determine if a liquidated damages clause can be used to recover idiosyncratic value. The inclusion of the penalty is also much cheaper than third party insurance that would presumably compensate for the idiosyncratic harm to the injured party.

21. 326 F. Supp. 1331 (E.D. Pa. 1971).

the damages sought were too speculative[22] and that punitive damages were not recoverable for breach of contract.[23] If a penalty clause had been available, the value the Carpels attached to the photographs could have been incorporated into a penalty provision, assuming, of course, that the studio consented. This would have made the harm sustained by the Carpels measurable and compensable. In similar situations, the affected party could mitigate his potential losses and receive some compensation for the idiosyncratic harm by including a penalty provision in the contract.

In *Carpel*, the Carpels negotiated the photography contract despite their inability to include a penalty provision. To this extent, some efficiency was achieved. The result would have been more efficient if they could have inserted a clause into the contract reimbursing them for the idiosyncratic harm.

2. *Penalty provisions convey information about the reliability of one party's performance*

Another reason for enforcing a penalty clause is that it conveys information about one party's reliability and ability to perform under the contract.[24] Suppose, for instance, that there is a relatively new contractor in the community with no extensive experience and no reputation. He or she can offset the concerns another party might have about his or her ability to perform by allowing a penalty provision in the contract. This provision would convey information to the other party about the inexperienced party's reliability and determination to accomplish the task. If the inexperienced party breaches, then the other party is compensated to the extent of the penalty; if the inexperienced party does not breach, then the penalty provision has indeed conveyed information that would otherwise have been unavailable or difficult to obtain. Both parties have benefitted and so, presumably, has society. Although other avenues may exist to convey this information, a penalty provision is an inexpensive, simple, and useful way to convey this type of information.

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22. *Id.* at 1333.
23. *Id.* at 1334.
24. *See generally* COOTER & ULEN, *supra* note 12, at 295; POSNER, *supra* note 7, at 116.

3. Penalty clauses efficiently allocate risk between the parties

Penalty clauses efficiently allocate risk. A risk averse party may transfer part of the inherent risk of a transaction by demanding that the more risk neutral party assume the risk of breach. However, uniform application of the penalty rule discourages this type of efficient risk transfer and imposes inefficient costs on parties wanting to neutralize the risk factor.

Along these same lines, the inclusion of a penalty provision may be considered as a form of insurance from the breaching party to the innocent party.[25] This would occur when one party places a high subjective value on performance of the contract and the other party is best able to provide the insurance necessary to compensate for harm to the subjective value.[26]

For instance, suppose a couple wants a house built in time for their daughter's wedding. Because the couple wants everything to be perfect for the wedding, they place a high value on having the work completed on time. Indeed, it would be impossible for a third party to objectively place a dollar value on this. To insure against a possible delay, a penalty provision in the contract would be a logical way to obtain compensation for the subjective value the couple places on having the house built on time. A penalty clause is efficient because the couple thereby obtains the insurance they need, and the builder is the most efficient insurance provider because she is best able to ensure the project's timely completion. If delay is expected, the builder knows the costs involved and is able to balance the penalty provision payment with the cost of assuring that the delay is not excessive. Such a scenario is also efficient because only two parties are involved instead of three or more, such as a court or third-party insurer.

E. Practical Considerations Support the Use of Penalty Clauses

1. Litigation economies would be promoted

Practical considerations indicate that the penalty rule

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25. COOTER & ULEN, *supra* note 12, at 293 (quoting Goetz & Scott, *supra* note 7, at 579).
26. *Id.*

should be discarded. For example, courts would be less burdened if they did not have to consider whether a liquidated damages provision is valid as a reasonable estimate of damages or is instead invalid per se as a penalty provision. Courts lack the resources for this determination. Indeed, with no clear rule on the matter, most courts proceed on an ad hoc basis to determine from the particular facts whether the provision is valid. As Kaplan noted:

> More liberal enforcement of liquidation agreements would result in reduced litigation expenses. To begin with, proof of damages—often an exceedingly complex and time-consuming process—would be removed from issues at trial. This would save time and money for the courts as well as the parties, in both pretrial preparation and courtroom time. In general, the trial would be more efficient because the number of issues before the court would be reduced.[27]

2. *The current rule is confusing*

Another practical reason for allowing a penalty clause is that the current rule is confusing. Courts struggle in deciding whether a liquidated damages clause is a reasonable expectation of future loss or is instead unreasonable and, therefore, void as a penalty. In addition, the tests used to distinguish the penalty from a valid liquidated damages provision are inconsistent and not uniformly applied. For instance, some courts require three conditions for enforcement of a liquidated damages clause: 1) the parties must intend to provide for liquidated damages and not a penalty, 2) the damages must be difficult to ascertain, and 3) the estimate of damages must be reasonable.[28] Other courts require that only the second and third conditions be met.[29] The court decisions necessarily turn on highly subjective determinations of whether a provision is reasonable and, if intent is required, what the intent of the parties was at the time of contracting for the provision. Although courts make these subjective inquiries in other types of cases,

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27. Kaplan, *supra* note 7, at 1057-58 (footnote omitted). For additional support for the general proposition that "more liberal enforcement of liquidation agreements would result in reduced litigation expenses," see *id.* at 1057 n.7.
28. Clarkson et al., *supra* note 7, at 353.
29. *Id.*

courts should avoid such subjective determinations when possible.

Furthermore, even if the parties agree that a provision is a liquidated damages clause and not a penalty clause, the court's decision is independent of the parties' agreement.[30] In *In re Sherwoods*, a lessee deposited $2500 with a lessor to be held as security "for liquidated damages and not as a penalty."[31] Although the parties agreed that the $2500 was not a penalty, the court decided that whether a contractual provision is a valid liquidated damages clause or void as a penalty is a question of law and "quite independent of the agreement of the parties to call it the one or the other."[32] Absent evidence of wrongdoing, a court's independent judgment of an agreed principle needlessly complicates and obfuscates what the parties have already agreed upon. The court's interference adds confusion to a perhaps already complicated case.

Generally, "[i]t is impossible to lay down any abstract rule to determine if a pre-estimate of damages is unreasonable, for each case must, in great measure, depend on its own particular facts and circumstances."[33] And if the damages are "'doubtful, speculative, and difficult of proof,'" even if "'the amount stipulated is much larger than the apparent actual injury and loss,'"[34] a court may still determine that this is a valid liquidated damages provision. Needless to say, the rule and standards involved are somewhat nebulous.

Even if the parties use the word "penalty," some courts hold that the clause is one for liquidated damages.[35] Other courts say that the word "penalty" is "generally conclusive against the stipulated sum being held to be liquidated damages, however strong the language of other parts of the instrument favor such construction."[36] The Supreme Court has said that "[e]ither expression is not always conclusive as to the meaning of the parties."[37] This result also adds undue subjec-

30. 22 AM. JUR. 2D *Damages* § 695 (1988).
31. *In re* Sherwoods, Inc., 210 F. 754, 760 (2d Cir. 1913).
32. *Id.*
33. 22 AM. JUR. 2D *Damages* § 703 (1988) (footnote omitted).
34. Meuwissen v. H. E. Westerman Lumber Co., 16 N.W.2d 546, 550 (1944) (quoting Taylor v. Times Newspaper Co., 86 N.W. 760, 762 (1901)).
35. *See* 22 AM. JUR. 2D *Damages* § 696 (1988).
36. *Id.* at 754-55.
37. United States v. Bethlehem Steel Co., 205 U.S. 105, 120 (1907).

tivity to the analysis.

Finally, courts are split on whether the validity of a liquidated damages provision is a question of law or fact.[38] Again, the result is unnecessary confusion, and under any scenario the process of pigeonholing the damages stipulation is an inefficient allocation of scarce judicial resources.

F. *Penalty Clauses Allow the Nonbreaching Party to Share Efficiency Gains*

Another reason for allowing penalty clauses in contracts is that under the current rule, only the breaching party enjoys efficiency gains. The breaching party will choose to breach the contract when her gains from breach are maximized. This leaves the nonbreaching party with little ability to maximize gains from a breach. Allowing the nonbreaching party to insert a penalty provision would establish a more level playing field by discouraging the other party from breaching. If a breach did occur, then the nonbreaching party would at least receive part of the breaching party's benefits.

To a certain extent, the playing field may be level already since both parties have the option of breaching. But the field becomes uneven to *A*, for example, immediately upon *B*'s breach. To the extent *A* may keep the field somewhat level through the use of a penalty provision, she should be able to do so.

III. JUSTIFICATIONS FOR ELIMINATING PENALTY CLAUSES

A. *Penalty Clauses Are Punitive, Not Compensatory*

Some support exists for the penalty rule. The Restatement's rationale for the penalty rule is that the "central objective behind the system of contract remedies is compensatory, not punitive."[39] The Restatement argues further that "[p]unishment of a promisor for having broken his promise has no justification on either economic or other grounds and a term providing such a penalty is unenforceable on grounds of public policy."[40] However, the Restatement view ignores the fact that a penalty provision is oftentimes included to compensate the

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38. 22 AM. JUR. 2D *Damages* § 692 (1988).
39. RESTATEMENT (SECOND) OF CONTRACTS § 356 cmt. a (1981).
40. *Id.*

nonbreaching party in case the contract is not concluded. As already mentioned, one compensatory measure might be for the idiosyncratic harm suffered by the nonbreaching party as a result of the breaking of the contractual relation.

Furthermore, "public policy" is a woolly issue and is not easily defined. The blanket statement that neither economic nor other grounds justify a penalty provision simply is not in accord with emerging evidence and opinion.[41] The Restatement position appears to be nothing more than a blanket assertion of an outdated rule.

B. *Penalty Clauses Discourage Efficient Breaches*

Another rationale for the penalty rule is that the efficient breaching of contracts should be encouraged.[42] If, for instance, a breaching party has contracted to receive $35 but, by breaching the contract, can earn an additional $15 plus any amount necessary to cover damages, then this breach should be encouraged. But, as the court in *Lake River* emphasized,

> [T]he willingness to agree to a penalty clause is a way of making the promisor and his promise credible and may therefore be essential to inducing some value-maximizing contracts to be made. It also overlooks the more important point that the parties (always assuming they are fully competent) will, in deciding whether to include a penalty clause in their contract, weigh the gains against the costs—costs that include the possibility of discouraging an efficient breach somewhere down the road—and will include the clause only if the benefits exceed those costs as well as all other costs.[43]

Eliminating the penalty rule merely implies that the party who might find it profitable to breach should consider before signing the contract whether the opportunity to do so in the future might be available. The potential costs of not efficiently breaching the contract because of a penalty provision must be weighed against the benefits of the rule and a decision reached on whether to include the penalty provision. Factoring in these variables does imply some extra effort and expenditure of re-

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41. *See supra* note 7 and accompanying text.
42. POSNER, *supra* note 7, at 116.
43. Lake River Corp. v. Carborundum Co., 769 F.2d 1284, 1289 (7th Cir. 1985).

sources, but nothing suggests that this cost is prohibitive or unwieldy. Forecasting always involves some element of risk. But parties to a contract, especially those involved in sophisticated transactions, are constantly evaluating similar variables and reaching decisions on how best to proceed.

Although contracting parties cannot precisely predict the future, past experience and the balancing of risk allow them to adequately deal with uncertainty. Disallowing penalty clauses obfuscates the balancing of risk and discourages efficiency.

C. *The Penalty Rule Helps Prevent Bilateral-Monopoly Problems*

The penalty rule is also justified by proponents because it helps prevent bilateral-monopoly problems.[44] Bilateral-monopoly problems are created when the increased price to break the contract forces both parties to deal with each other instead of breaking the contract and dealing with other parties. This has the potential of increasing transaction costs. However, when two parties have freely negotiated a penalty provision, they will include a penalty provision only if the gains outweigh the costs. Parties should expressly consider the potential bilateral-monopoly problem that is created. Unsophisticated parties will intuitively deal with the problem by balancing the benefits and the costs involved with the transaction.

A more efficient avenue of dealing with the potential bilateral-monopoly problem would be to invoke legal principles such as contract adhesion or unconscionability that could mitigate the behavior of the party who has obtained an advantageous position as a result of the penalty provision. Instead of eliminating penalty provisions completely, penalties should be allowed with perhaps a heightened awareness of potential problems of bilateral-monopolies.

D. *The Penalty Rule Prevents Some Forms of Fraudulent Conduct*

A penalty might induce one party to provoke a breach of contract by the other party, thus forcing the payment of the penalty by the breaching party.[45] This is described as wager-

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44. POSNER, *supra* note 7, at 116.
45. *Id.*

ing, which courts will not enforce.[46]

Wagers differ from aleatory contracts in that wagers "*create* a risk which is assumed by the promisor while other aleatory contracts merely shift to the promisor a risk which exists before the contract is formed."[47] Contracts with a penalty provision are often methods of allocating risk and are "more akin to legitimate forms of market speculation, such as hedging, option, or futures contracts, than they are to conventional gambling."[48]

Some argue that as a matter of public policy, a penalty clause should be unenforceable because a party might insist on its inclusion in a contract as a wager—gambling on whether the other party would breach and therefore have to pay the penalty. The difficulty with this rationale is in determining whether the penalty clause represents a wager or whether the clause represents a legitimate avenue of risk allocation. The idea of the penalty rule appears to be more a way of allocating risk than wagering, and without empirical support, the wagering argument appears without foundation.[49] "The danger of wagering seems sufficiently remote to leave invalidation to explicit proof of a gambling transaction, rather than using it as a rationale for invalidating all agreements which allocate risks based on unprovable reliance."[50] Furthermore, existing legal restraints on wagering are probably adequate to prevent the widespread use of penalty provisions as a form of gambling.[51]

E. The Penalty Rule Alleviates Unequal Bargaining Involved in Contract Negotiations

Courts fear that a party in an unequal bargaining position will be harmed by the more powerful party who insists on inserting a penalty provision into the contract. Along these same lines, another rationale for nonenforcement of a penalty provision is that given where one party has access to superior information and insists on including a penalty provision in the contract, knowing that it will be impossible for the other party to

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46. Kaplan, *supra* note 7, at 1072 (footnote omitted).
47. *Id.* at 1074.
48. *Id.* at 1073.
49. Goetz & Scott, *supra* note 7, at 584.
50. *Id.*
51. *Id.* at 586.

perform.[52] The party insisting on the penalty provision would thereby reap a windfall. An example of this would be an executive who hires a cement company to perform some service, knowing that the supply of gravel from a local quarry needed to make the cement will not be available because of an imminent strike. The executive could insist on the penalty provision, knowing that ultimately the cement company would be forced to breach because of the inadequate gravel supply. However, as is the case with bilateral-monopolies, other legal doctrines, such as unconscionability, impossibility, or frustration of contract, could be used by the cement company to invalidate the contract.

F. The Penalty Rule Assumes that Parties Only Receive Just Compensation for a Breach

The penalty rule is "founded upon the principle that one party should not be allowed to profit by the default of the other, and that compensation, and not forfeiture, is the equitable rule; the injured party is not allowed to recover more than a just compensation or obtain a collateral advantage."[53] One of the rationales for striking down the penalty provision is that the function of the court in civil disputes is to award compensatory damages instead of punitive damages.[54] But this rationale contradicts the fact that courts do award punitive damages in some civil cases such as torts (though not in the area of contracts).[55] Uniformly striking down penalty provisions is thus inconsistent with the legal philosophy that does allow punitive damages in some civil cases.

G. The Penalty Rule Prevents Inefficient Breach-Inducing Activities and Also the Inefficient Use of Resources in Preventing Breach-Inducing Activities

A party might be tempted to induce a breach of contract if the penalty imposed on the breaching party is high enough to compensate the party to induce a breach. But breach-inducing activities do not create wealth and are inefficient. Resources

52. COOTER & ULEN, *supra* note 12, at 296 n.33.
53. 22 AM. JUR. 2D *Damages* § 727 (1988).
54. *See supra* notes 1-3 and accompanying text.
55. COOTER & ULEN, *supra* note 12, at 293.

are also wasted in preventing breach-inducing activities.

> [T]he value of *all* resources expended in inducement is wasted and increases the costs of forming, completing, and monitoring the contract . . . . If these costs could be avoided while retaining the desirable outcomes of stipulated damage clauses (and without incurring any new costs), contracting parties as a group, and hence society, would gain.[56]

Proponents of the penalty rule argue that a blanket prohibition of penalties would take away the incentive to induce a breach of contract and would free up the resources of the court by not requiring it to examine the breach-inducing activity for wrongdoing. However, this reasoning ignores the benefits of the penalty provision. One might just as well argue with the same logic that judging contract disputes takes considerable court time, and that contracts should be eliminated. This would be absurd; yet the same rationale is often applied to justify the penalty rule. The problem is finding the delicate balance of preventing the breach-inducing activity while still retaining the benefits of stipulated damages clauses. This is not easily accomplished.

H. The Penalty Rule Is Supported by Stare Decisis

Some would argue that the penalty rule should be retained because of stare decisis. However, when a valid reason no longer exists to preserve a rule, it should be discarded or at least refined. The court in *Lake River* strongly urged that the rule be discarded. But because it was a federal court with diversity jurisdiction applying state law, the court felt it was up to state courts to refine the rule.[57]

I. The Penalty Rule Prevents Adverse Economic Effects

Arguments have been made that penalty provisions amplify the business cycle by increasing the number of bankruptcies during periods of economic downturn.[58] Although a penalty

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56. Clarkson et al., *supra* note 7, at 370-71.

57. Lake River Corp. v. Carborumdum Co., 769 F.2d 1284, 1289 (7th Cir 1985).

58. *Id.* There does not seem appear to be much evidence pointing toward this result, and it seems doubtful that penalty clauses could have such cataclysmic consequences to the national economy.

might increase the breaching party's costs, it must be kept in mind that two parties who contract to such a provision have implicitly weighed the costs and benefits and have efficiently allocated the risk involved in entering the contract.

J. The Penalty Rule Is Efficient

Evidence indicates that the common law promotes economic efficiency.[59] Therefore, the inevitable conclusion is that because the penalty rule has existed for so long, the distinction between liquidated damages and penalties provides "indirect support . . . that the cases have produced an efficient result."[60] But no one would argue that every rule in the common law promotes efficiency. The Goetz and Scott analysis suggests that the penalty rule is inefficient and should be reformed.[61]

K. Penalty Clauses Create Negative Externalities

In a freely bargained exchange, all implicit and explicit costs are generally incorporated. There can, however, be a market failure or externalities associated with a freely bargained contract where the contracting parties both benefit from the exchange but third parties are injured. Although the reasoning has been poorly articulated, perhaps the courts are attempting to prevent this type of negative externality when a liquidated damages clause that is perceived as a penalty is eliminated from the contract. For instance, suppose *A* insists that *B* pay a penalty of $500,000 upon breach of a contract for *B* to build a $200,000 home. For *A*, assume damages in event of breach would be $50,000. Further, suppose that *C* is willing to pay *B* $300,000 for the construction of a home, provided that *B* begin immediately. (*B* does not have enough equipment to do both). At first glance, it would appear most efficient for *B* to

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59. Clarkson et al., *supra* note 7, at 390 (citing RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 10-100 (2d ed. 1977)).

60. *Id.* Clarkson et al., seem to have undercut their own analysis at this point by citing Posner's assertion that the common law "promotes the efficient exchange and utilization of society's scarce resources." RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 10-100 (2d ed. 1977). Although Posner finds that the common law generally does promote economic efficiency, Posner himself has become an inveterate foe of the penalty rule, arguing that it is economically deficient and anomalous to the general trend of the common law toward economic efficiency. See POSNER, *supra* note 7, at 116, for his general views.

61. Goetz & Scott, *supra* note 7, at 594.

breach her contract with *A*, pay the compensatory damages, and then construct *C*'s home. *A* is compensated, *B* earns more money, and *C* has his new home. But the penalty that *B* must pay ($500,000) prevents this result.

The danger of this approach is that courts rarely have the capability, knowledge, or resources to determine whether the disadvantages of externalities outweigh the advantages. Courts are simply poorly equipped to make these types of economic decisions. Indeed, there can be positive as well as negative externalities. For instance, suppose a contractor and subcontractor agree that the subcontractor will pay a penalty to the general contractor for any late work performed on the construction of a house. If the penalty is enforced, the subcontractor will likely perform and the house will probably be completed on time. On the other hand, if the penalty provision is not enforced, a delinquent subcontractor will lack incentive to complete the work on time. The disadvantage of the uncompleted house might outweigh any negative externality associated with the penalty provision. Courts should rarely attempt to balance these complex trade-offs.

A court should only attempt this complex balancing process if compelling evidence indicates that the penalty clause contains negative externalities that outweigh the benefits of enforcement.

IV. CONCLUSION

The penalty rule throws the baby out with the bath water. Instead of invalidating penalty clauses, courts should scrutinize the bargaining position of the respective parties at the time the clause was negotiated. Absent some blatant inequality, courts should enforce penalty clauses. Penalty clauses are an efficient means by which contracting parties can allocate risk, provide compensation in the event of breach, or convey information about a party's intent or capability to perform.

If the court is convinced that wrongdoing affected the bargaining process, other legal doctrines such as unconscionability could provide adequate redress.[62]

Invalidating a penalty clause ignores the fundamental economic tenet that absent fraud or duress, when two parties

62. POSNER, *supra* note 7, at 116; Goetz & Scott, *supra* note 7, at 594.

enter into an arm's length transaction, both improve their respective economic positions and society benefits. When a court attempts to reconstruct a contract by invalidating a penalty provision, inefficiencies often result.

Allowing penalty clauses in contracts would conserve scarce judicial resources by allowing courts to concentrate on other issues. Both parties would benefit by inserting penalty clauses, and the freely bargained contract would inure to the benefit of society as well.

David Brizzee