OVERBROAD: A CASE AGAINST THE PENALTY RULE IN LIQUIDATED DAMAGES CLAUSES

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INTRODUCTION

Sometimes at contract formation, the parties will agree to a provision setting forth the remedial compensation to be paid to the non-breaching party in the event of a breach. Such provisions are known as liquidated damages clauses and are valid and enforceable under the fundamental principle of freedom to contract. [1] However, a court reviewing a contractual dispute will strike down a liquidated damages clause as void and unenforceable if it considers the provision to be a *penalty* – punishment rather than compensation for a party's default used to secure performance.[2] The Restatement (Second) of Contracts states the rule against penalties in liquidation clauses as follows:

> "Damages for breach by either party may be liquidated in the agreement, but only at an amount that is reasonable in the light of the anticipated or actual loss caused by the breach, and the difficulties of proof of loss. A term fixing unreasonably large liquidated damages is unenforceable on grounds of public policy as a penalty." [3]

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1. Williston on Contracts, § 65:1, Validity of Provisions for Liquidated Damages, Generally (4th ed. 2010).

2. "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, or by way of security for actual damages which may be sustained by reason of nonperformance, not as the measure of compensation for breach of the contract, the stipulation is a penalty and is invalid and nonenforceable." Annotation, *Contractual Provision for Per Diem Payments for Delay in Performance as One for Liquidated Damages or Penalty*, 12 A.L.R. 4th 891, § 2[a] Summary and Comment Generally, 1982.

3. Restatement (Second) of Contracts, § 356 (1) Liquidated Damages and Penalties (1981.)

In essence, the rule provides that liquidated damages clauses will be void as a penalty, which limits the non-breaching party to conventional damage measures, unless: (1) the amount liquidated was reasonably proportional to the anticipated or actual harm; and (2) the valuation of expected damages arising from the anticipated breach was difficult to ascertain at the contract's formation. This result prevails despite the contextual circumstances surrounding the deal, such as where the provision is negotiated in good faith, at arm's length, and between parties of equal bargaining power. [4] The Uniform Commercial Code – substantially adopted into most states' statutory codes, provides *essentially* the same version of the rule. [5]

Accordingly, between state codification and rigorous application of the rule at common law, the rule against penalties is deeply entrenched into American Jurisprudence, but why should this be so? Why should a court's determination of reasonable damages supersede the parties' discretion and void their contract's term when they have already deemed the appropriate measurement for damages?

What follows is an argument that the rule against penalties is overbroad, and therefore, courts should enforce a contract's liquidated damages clause in special circumstances even when considered a penalty under current standards. To establish this argument, the discussion will proceed in three parts, which will be broken into sub-parts. Part I will introduce an economic basis for questioning the penalty rule as a general theme. Part II will explore various rationales supporting the penalty rule, and culminate with an evaluation of the policy relationships it shares

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4. *See* Williston on Contracts, §65:1 (4th ed. 2010).

5. "Damages for breach by either party may be liquidated in the agreement but only at an amount that is reasonable in the light of the anticipated or actual harm caused by the breach and, in a consumer contract, the difficulties of proof of loss, and the inconvenience or nonfeasibility of otherwise obtaining an adequate remedy." U.C.C. § 2-718 Liquidation or Limitation of Damages, Deposits (1) 2003. This rule, however, incorporates the inconvenience or infeasibility of otherwise obtaining an adequate remedy, an issue tangential to the argument, which will not be addressed.

with other doctrines limiting free contracting. Finally, **Part III** will proceed with a critical examination of these rationales, highlight their contextual shortcomings, and ultimately, provide various justifications, which support a common sense acceptance of the following argument.

ARGUMENT

The penalty rule is not wholly without merit and its application is valid in certain contractual situations, such as those involving unsophisticated or vulnerable parties, or where bad-faith or other wrongful behavior is present. However, the rule is overbroad, and therefore, it should be modified. It should not apply in special contractual situations where both parties are highly sophisticated, dealing at arm's length, and share equal bargaining power – for example, a contract between two large corporations as opposed to a consumer contract. Throughout the remaining discussion, this special contractual situation will be referred to as an "*ideally negotiated contract*." The penalty rule should not apply in such situations because when equal parties bargain freely, their contractual dealings maximize net economic efficiencies and other advantages, which are mutually beneficial to the parties as well as society.

Conversely, applying the penalty rule under these circumstances is fundamentally illogical. In this context, the costs and other detriments may outweigh the negative consequences it seeks to prevent while contradicting the principle goal of contract law – maximizing economic efficiency. Furthermore, enforcing the rule is arbitrarily paternalistic in these situations: it restricts the parties' freedom to contract by overriding their intentions, when alternate doctrines provide the same legal protections without the unwanted results – an invalidation of freely negotiated penalty clauses, causing under-compensated remedies and opportunism. Nevertheless, given the rule's deep-rooted acceptance in America's legal system, what basis justifies a reassessment of the doctrine's credibility?

I. QUESTIONING THE PENALTY RULE

It seems rather peculiar that if a legitimately negotiated contract contains a liquidated damages clause, which a court subsequently deems is a penalty, the provision will be struck down as void and unenforceable, regardless of the *parties' intentions* at contract formation. However, this is exactly the counterintuitive result, which repeatedly appears throughout a review of common law opinions. [6]

Perhaps Judge Richard A. Posner best provides a common sense basis to question the penalty rule when he called the doctrine "a major unexplained puzzle in the economic theory of the common law." [7] As recently as 2004, he advanced the following:

> "[t]he reason for the rule is mysterious; it is one of the abiding mysteries of the common law. At least in a case such as this, where both parties are substantial commercial enterprises… and where damages are liquidated for breach by either party, making an inference of fraud or duress implausible, it is difficult to see why the law should take an interest in whether the estimate of harm underlying the liquidation of damages is reasonable. Courts don't review the other provisions of contracts for reasonableness; why this one?" [8]

He expounds on his commentary by adding the following:

> '"[t]he explanation for the rule against penalty clauses may be purely historical- and "it is revolting to have no better reason for a rule of law than that so it was laid down in the time of Henry IV… [T]he slow pace at which the common law changes makes it inevitable that some common law rules will be vestigial, even fossilized… [T]he rules of contract law have remote origins, predating the era of freedom of contract and the ideology of free markets."' [9]

6. An analysis of the case law indicates that a penalty clause will be invalidated regardless of the intention of the parties. *See*, A. Corbin, Corbin on Contracts: A Comprehensive Treatise on the Working Rules of Contract Law § 1058 (1964).

7. Richard A. Posner, *Some Uses and Abuses of Economics in Law*, 46 U. Chi. L. Rev. 281 (1979) at 290.

8. *XCO Intern. Inc. v. Pacific Scientific Co*, 369 F.3d 998, 1001, (7th Cir. 2004).

9. *Id*. at 1002.

Posner's comments not only highlight the seemingly arcane, if not arbitrary, basis for applying the penalty rule in such situations, but more importantly, they direct us to one of the most compelling reasons to reconsider the courts' strict adherence to the rule – the concept of contractual freedom.

A. THE IMPORTANCE OF CONTRACTUAL FREEDOM

The central principle of classical contract theory from an economic perspective is that if commerce transpires via freely negotiated bargains, efficiencies are maximized as resources are allocated at their highest values while transactional costs are minimized. [10] From a macro perspective, the premise underlying this theory relies on a presumption that the market has a freedom to contract – that bargains will be honored and voluntary promises exchanged, will ultimately, be enforceable. [11]

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10. The classical legal model of contract "is without doubt based on an economic model, that of the free market." P. S. Atiyah, *The Rise and Fall of Freedom of Contract*, (Oxford: Clarendon Press, 1979); M. J. Trebilcock, *The Limits of Freedom of Contract*, (Cambridge, MA: Harvard University Press, 1993); Within neoclassical economics, freedom of contract holds a singular status, nearly equivalent to that of a natural right. Indeed, an oft-recited theme in the law and economics literature is that when individuals act rationally, and transaction costs are negligible, restrictions on contractual freedom cannot enhance economic efficiency. *See* R.H. Coase, *The Problem of Social Cost*, 3 J.L. & Econ.1 (1960); Anthony T. Kronman & Richard Posner, *The Economics of Contract Law*, 2,3 (Boston: Little, Brown and Company 1979). The basic principle underlying the complex concept of economic efficiency is that an economy will be deemed to operate efficiently only if all available goods and resources are utilized in their most productive manner. *See Id.*

11. "The goal of contract law is to hold parties to their agreements so that they receive the benefits of their bargains." Williston on Contracts § 1:1 (4th ed. 2010); "*These rules are designed to allow the parties the greatest freedom of contract* while [also] preventing them from overstepping that freedom by including illegitimate penal provisions." *See Id*. (emphasis added); "[T]he 'bargain theory' underlies and is fundamental to the common law of contract… [T]he agreed terms of a contract should generally be enforced. Freedom of contract is the basis of a market economy so that individuals and other legal entities must be given the right to determine their own contractual arrangements… Firms and individuals draw up contracts in order to produce, distribute and sell goods and services. Contracts and contract law facilitate exchange and production, and freedom of contract is a necessary part of a market economy. It is therefore no surprise to learn that legal concepts of contract law have their roots in economics and commercial practice." Cento Veljanovski, *Economic Principles of Law*, 109 (Cambridge University Press, New York 2007).

Evaluating the precept from a micro perspective, parties to enforceable contracts intend to maximize their personal utility; accordingly, when arms' length transactions are negotiated between highly sophisticated parties with relatively equal bargaining power economic efficiencies must emerge, because otherwise, the parties' would never have contracted in the first place. [12] This concept is elementary considering economist Adam Smith's themes on the topic:

> "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." [13]

Obviously, there are risks inherent in every transaction due to bounded rationality. Parties may suffer from an ex-ante miscalculation or lack of information regarding expected costs, profits, or other risks, which may lead to a proportionally worse deal for one side. [14] However, such results are inherent in all business propositions, reflect the risk-shifting function intended by the law, and finally, they don't normally receive contractual protection. [15]

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12. "A complex of social propositions supports the bargain principle. Parties are normally the best judges of their own utility, and normally reveal their determinations of utility in their promises. Bargain promises are normally made in a deliberative manner for personal gain, and promises so made should normally be kept. Bargains normally create value, enable the parties to plan their future conduct reliably, allocate commodities to their highest-valued uses, and best distribute the factors of production, and the enforcement of bargain promises promotes these desirable ends. Ultimately, these propositions, and therefore the bargain principle itself, rest on the empirical premise that in making a bargain a contracting party will act with full cognition to rationally maximize his subjective expected utility." Melvin Aron Eisenberg, *The Limits of Cognition and The Limits of Contract*, 47 Stan. L. Rev. 211, 211-212 (1995).

13. Milton, Friedman, and Rose Friedman**,** *Free to Choose: A Personal Statement*, pg. 5 (1981).

14. "The simplest 'model' of bounded rationality is that people make mistakes. They fail to foresee all possible contingencies and, thus, their contracts suffer." Benjamin E. Hermalin, Avery W. Katz, and Richard Craswell, *The Law & Economics of Contracts*, The Handbook of Law & Economics (2006).

15. "[Contract law] is intended to enforce the expectancy interests created by the parties' promises so that they can allocate risks and costs during their bargaining. It is not the function of the court to relieve a party to a freely negotiated contract of the burdens of a provision which becomes more onerous than had originally been anticipated." Williston on Contracts § 1:1.

Nevertheless, the concept of bounded rationality does not change the fact that during contact formation, no third party judge or legislator is in a better position to gage a transaction's prospects and maximize the benefits of a deal than the parties themselves. Adam Smith stated as much when he said, "[e]very individual, it is evident, can, in his local situation, judge much better than any statesman or lawgiver can do for him." [16] Moreover, bounded rationality also doesn't displace the presumption that notwithstanding situations involving wrongdoing on one side – such as fraud or duress, which inhibits the other's access to information or diminishes his value under the deal – the lack of perfect information doesn't prevent any bargain the parties voluntarily reach from being mutually beneficial, and therefore, efficient. [17]

In other words, the contracting parties have the most information regarding their individual situations and the circumstances surrounding their potential transaction; consequently, they are *necessarily* in the best position to maximize their respective interests by freely negotiating the terms to their contract. Under this presumption, commercial efficiently flourishes when parties are granted wide discretion to define the parameters of their dealings considering the superior knowledge they posses. As a corollary, this concept is only compounded in circumstances where the parties aren't only deemed ex-ante inherently rational – relative to all the outsiders to their deal – but in addition, are highly sophisticated commercial entities with equal bargaining power engaged in an arms' length transaction.

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16. Robert L. Heilbroner, *The Essential Adam Smith*, 265 (1986).

17. "The economic approach assumes that, generally, the parties are the best judge of their own welfare. This is the presumption in law also, but it is one that in both law and economics can be overturned when one party has been misled, defrauded, or coerced… The starting point for the analysis of contracts in both law and economics is the presumption that exchange is mutually beneficial. The parties enter in to a contract because both gain. At the moment of making the contract, each party can be assumed to value the promise of the other more than (or at least as much as) any alternative." Veljanovski, *Economic Principles of Law* at 111.

Coming full circle – aside from the seemingly obvious efficiencies gained through ideally negotiated contracts – it's only natural to presume that because efficiencies are maximized between all freely contracting parties, society must also enjoy similar gains resulting from such exchange. This correlation is not without justification and is supported by prominent economic viewpoints. [18]

This realization underscores the vital importance of contractual freedom generally: by allowing parties wide discretion to set the parameters of their deals via the freedom to contract, society as a whole effectuates its goals as understood by the economic principles driving contract theory. However, as indicated, the penalty rule has long become a stable fixture in the law, so what are the rationales behind the rule?

II. RATIONALES BEHIND THE PENALTY RULE

As previously mentioned, the rule against penalties is not entirely without merit. Although a blanket application of the rule is questionable, considering other contractual doctrines existing today, it still has some rational basis – economic and otherwise. To understanding the rationales behind the penalty rule, we must first examine the reasoning behind its historical origins and the general nature of contract remedies.

A. CONTRACT REMEDIES

Historically, "[r]elief against penalties was one of the earliest exercises of equitable interference, having developed during the fifteenth century when the common law had no

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18. "Bargained for exchange, the predominant activity governed by contract law is very important because it represents a powerful method of curing misallocations of goods and resources. Two fundamental premises of economic theory are that people are rational, and that they strive to maximize their own welfare. Together, these imply that given the opportunity for gain, people will always engage in trade, and by exchanging assets for those that they value relatively more, they, apart from benefiting themselves, unwittingly help society progress toward the goal of economic efficiency." Henry Gross, 80 Colom. L. Rev. 4, at 868 (1980), reviewing Anthony T. Kronman and Richard A. Posner, *The Economics of Contract Law*, 269 (Boston: Little, Brown and Company 1979)

adequate machinery for trying cases of fraud." [19] This seems justified because contractual doctrines like unconscionability hadn't yet developed to protect against the ever-present forms of unfair bargaining that permeates all forms of commercial activity, then and now.

However, following an evolution in the common law, including development of the unconscionability doctrine, courts began justifying the invalidation of penalties under the principle of 'just compensation.' [20] Essentially, this principle provides it would be unfair to force a payment of contractual damages, which exceed the harm actually caused by beach; in other words, "parties should not be allowed to recover more than just compensation from the courts through a privately concocted alternative arrangement, even one fairly negotiated." [21] This principle endured, and now sets today's standard remedial measure of compensation for contract breaches – the comments to the Restatement (Second) of Contracts provide that:

> "[t]he central objective behind the system of contract remedies is compensatory, not punitive." The Restatement goes on to say, "[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." [22]

Accordingly, punitive damages traditionally aren't available for a breach of contract, rather, the remedy is predicated on compensating the non-breaching party with the value he expected to realize from the contract as opposed to being a mechanism used to compel performance from the other side; this measurement of compensation is known as an expectancy interest. The comments to the Restatement (Second) of Contracts define this interest:

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19. "Since there were no legal rules available to relieve against unconscionable bargains, equity filled the gap." *See* W. S. Holdsworth, *A History of English Law*, 292 (1924).

20. Goetz, Charles J. and Scott, Robert E., *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, 555 (1977).

21. *See Id*. at 560.

22. Restatement (Second) of Contracts, § 356, Liquidated Damages and Penalties, cmt. a (1981).

> "Contract damages are ordinarily based on the injured party's expectation interest and are intended to give him the benefit of his bargain by awarding him a sum of money that will, to the extent possible, put him in as good a position as he would have been in had the contract been performed." [23]

As mentioned, there is some foundational support for the penalty rule, and it comes from the same principle that drives classical contract theory and supports the freedom of contract generally – an attempt to maximize economic efficiencies. At first glance, this seems fundamentally counterintuitive. Realizing the goal of contract remedies is compensation, as opposed to punishment, when a freely negotiated liquidated damages clause stipulates an amount that unreasonably exceeds the expected actual harm resulting from breach, the clause will be voided as an illegitimate penalty, as has already been established. However, considering the discussion thus far, how can we rationalize the concept proposed above that freely negotiated bargains maximize efficiency, while *also* asserting that striking down some freely-negotiated 'penalty' clauses create efficient results?

B. THE CONCEPT OF EFFICIENT BREACH

There is longstanding recognition in the law that parties to an executory contract may voluntarily breach their obligations under the agreement by paying damages to remedy the harm resulting from their choice. The premise behind an enforceable contract is not that parties are obligated to perform their agreements, but rather, they must choose between rendering performance or breaching the contract and paying damages. [24] As written by Justice Holmes:

> "The only universal consequence of a legally binding promise is, that the law makes the promisor pay damages if the promised event does not come to pass.

23. Restatement (Second) of Contracts § 347, Measure of Damages in General, cmt. a (1981).

24. "The goal of the law of contract remedies has not been compulsion of the promisor to perform his promise but compensation of the promisee for the loss resulting from breach." Restatement (Second) of Contracts, intro. note to ch. 16 (1981).

> In every case it leaves him free from interference until the time for fulfillment has gone by, and therefore free to break his contract if he chooses." [25]

When a liquidated damages clause is considered a penalty, it is deemed *punitive* in nature as opposed to compensatory in that the agreed damages exceed expected returns on the contract, and therefore, it induces performance, which is contradictory to the goal of contractual remedies. This is because if such a clause were enforced, the non-breaching party would necessarily receive compensation in excess of his expectation interest under the contract. So how is non-enforcement of a freely negotiated contract term efficient? The answer to this patent contradiction is grounded in the concept of efficient breach, which when applied in the context of liquidated damages can provide economic advantages in certain contractual situations.

To clarify the confusion, perhaps the concept is best demonstrated with a simple hypothetical advanced by Judge Posner – a champion of efficient breach when the breaching party, in fact, generates efficient results. Consider the following:

> "In many cases, it is uneconomical to induce completion of performance of a contract. If a widget manufacturer, by breaching her contract with A and selling to B, can make enough to compensate A for his loss and still come out ahead, she should do so. The manufacturer is better off, A is no worse off, and the widgets end up with B, who values them most." [26]

This is an example of an efficient breach. If we accept the presumption that expectation damages – the established *limit* of remedial compensation owed for breaching a contract – are sufficient compensation for the non-breaching party's losses, then evidently, the above reasoning seems to create economic efficiencies in such situations. Alas, dissected from an economic

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25. Oliver Wendell Holms, Jr., *The Common Law*, 301 (1881).

26. Richard A. Posner, *Economic Analysis of Law*, 131 (5th ed. 1998); "Efficient breaches, that is, breaches that confer a greater benefit on the contract breaker than on the victim of the breach, in which event breach plus compensation for the victim produces a net gain with no losers and should be encouraged." *XCO Intern. Inc*., 369 F.3d 998 at 1001.

perspective, we derive the concept's rational essence; breach is efficient when the breaching party, after paying expectation damages, improves his financial position by not performing. [27]

Efficient breach has now become the standard explanation of why punitive damages, and therefore, penalty clauses, are disfavored remedies under modern contract law. [28] The Restatement (Second) of Contracts, judicial decisions, and a number of contracts casebooks and treatises rely on the theory of efficient breach to explain why punitive damages – and by their nature, penalty clauses, aren't allowed: it's presumed that enforcing penalties deters efficient breaches, which in turn, induces inefficient performance, and thus, creates waste. [29]

Intuitively, and consistent with the undeniable principles established in **Part I** regarding economic efficiencies, which are maximized through voluntary exchanges between rational parties, we acknowledge that something *must* be missing. If freely negotiated contracts containing impermissible penalty clauses maximize efficiency, yet, breaching those same contracts also produce efficiencies, a glaring contradiction remains. The answer resides in the compensatory limit to contract remedies. Although efficient breaches may yield efficiencies, such breaches will seldom *maximize* efficiencies as originally anticipated by the contracting

27. "[A] breach of contract will result in a gain in economic efficiency if the party contemplating breach… will gain enough from the breach to have a net benefit even though he compensates the other party for his resulting loss." Restatement (Second) of Contracts, intro. rptr's note to ch. 16 (1981).

28. William S. Dodge, *The Case for Punitive Damages in Contracts*, 48 Duke L. J. 4, 629, 632 (1999).

29. *See Id*; "If [the promisor] is forced to pay more than [the promisee's actual losses], an efficient breach may be deterred, and the law doesn't want to bring about such a result."; *Patton v. Mid-Continent Sys*., 841 F.2d 742, 750 (7th Cir. 1988) (Posner J); "A penalty would deter efficient *as well as inefficient breaches*, by making the cost of the breach to the contract breaker greater than the cost of the breach to the victim…" Richard Posner, *Economic Analysis of Law*, 131, note 4 at 142 (5th ed. 1998) (emphasis added); "Punitive damages should not be awarded for breach of contract because they will encourage performance when breach would be socially more desirable." Allen Farnsworth, *Contracts,* § 12.3, at 157 (2d ed. 1998); "To prevent [efficient breach] by compelling performance, *it is argued*, would result in a less efficient distribution of wealth since the party in breach would lose more than the injured party would gain." Restatement (Second) of Contracts, intro. rptr's note to ch. 16 (1981); *See* Richard Craswell, *Contract Remedies, Renegotiation, and the Theory of Efficient Breach*, 61 S. Cal. L. Rev. 629 (1988).

parties, and any such efficiency gain certainly won't be enjoyed by the non-breaching party – who is arguably just an innocent bystander – when the other side unilaterally chooses to improve his financial position by breaching the contract. This will be discussed further in **Part III**. For now, it's worth exploring some other rationales supporting the penalty rule.

C. THE COST OF PERVERSE INCENTIVES

Some advocates justify invalidating penalties based upon their propensity to create 'perverse incentives' in the transaction – opportunistic circumstances where one party is motivated to exploit the penalty's obligation by inducing a breach of contract. This could occur where an enforceable penalty clause provides its beneficiary enough financial incentive to provoke the breach by actively interfering with the other party's ability to render performance. [30] This following hypothetical demonstrates the concept: Suppose X contracts with a Construction Co. to build a house by a certain deadline. If the company can't perform within the specified timeframe, X would incur $1,000 in actual losses; however, the parties negotiated a liquidated penalty clause providing X $5000 if the company misses the deadline. Here, X may be motivated by perverse incentives to induce such a breach. [31] As the argument goes, if X actively attempts to provoke the breach, to which, the company counters with additional measures to ensure its timely performance, ultimately, inefficiencies result regardless of the outcome. Under this scenario, rather than performing the contract efficiently, both sides engage in resources wasting activities – those aimed at inducing breach and those aimed at

30. Kenneth W. Clarkson, Roger Leroy Miller, & Timothy J. Muris, *Liquidated Damages v. Penalties: Sense or Nonsense?*, 54 Wisc. L. Rev., 351, 366-370 (1978).
31. Gerrit De Geest, *Penalty Clause and Liquidated Damages*, Encyclopedia of Law and Economics, 142-158, 149 (Boudeeijn Bouckaert & Gerrit DeGeest eds., 1998).

detecting, monitoring, and preventing this breach. [32] Although this anti-penalty rationale seems somewhat superfluous given doctrines such as bad-faith, which should nullify the clause on separate grounds, the risks proposed aren't *entirely* illogical if X could somehow induce the breach *without* being detected. Nonetheless, if this were the case, it seems X would be the only party actually wasting additional resources as all contracting parties typically monitor each other to some extent.

However, in a similar context, the following situation adds feasibility to the perverse incentive rationale: if performance becomes more difficult due to changes of circumstance – without becoming frustrated or impossible by contracting standards – inefficiencies may be compromised if performance becomes reliant on additional cooperation between the parties. Here, the danger of wasted resources becomes more viable, especially if preventing breach depends on good-faith contract modifications, which would be less valuable than receiving liquidated damages under an enforceable penalty clause. [33]

D. TRANSACTION & LITIGATION COSTS

Proponents of the penalty rule also suggest that creating liquidated damages clauses and enforcing penalty clauses produce additional transaction and litigation costs, which results in unnecessary inefficiencies. [34] As already established economic efficiency is maximized when transaction costs are minimized; accordingly, being critical of the increased transaction costs arising from the creation of and enforcement of penalty clauses can be justified.

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32. Kenneth W. Clarkson, Roger Leroy Miller, & Timothy J. Muris, 54 Wisc. L. Rev., 351 at 370.

33. *See* Eric L. Talley, *Contract Renegotiation, Mechanism Design, and the Liquidated Damages Rule*, 46 Stan. L. Rev. 1195, 1218-41 (1994).

34. Although penalty clauses aren't 'created,' but rather classified as such after a court makes this determination; this distinction doesn't change the rationale behind the argument presented here. Whether the clause is upheld or invalidated, proponents of the penalty rule believe creating such provisions produce additional transaction costs.

Acknowledging the effects of bounded rationality, parties will spend additional resources to negotiate and form a mutually beneficial liquidated damages clause; consequently, these contracts will cost more to create than similar contracts without such clauses. [35] This is understandable, as rational parties won't agree to the liquidated damages clause, unless they actually believe its inclusion maximizes their respective gains under the transaction. Therefore, the main reason transaction costs are increased is because, in order to form these contracts, rational parties will undoubtedly acknowledge their ex-ante lack of information and mitigate the associated risks by gathering the information necessary to confirm their belief that including the clause actually maximized value. Considering this, it's obvious why creating liquidated damages clauses increases transaction costs: rational parties won't include them without first insuring against unknown by diligently researching the various aspects of their bargain.

Another reason transaction costs are increased when creating a liquidated damages clause is because rational parties are attempting to circumvent remedial limitations for contract breaches while attempting to contract around unenforceability, otherwise, the parties would forgo the exercise. [36] If the parties agreed to include a liquidated damages provision, we presume that its inclusion was mutually beneficial. In addition, assuming the absence of bad faith, we can also presume that, at least during formation, they desire enforceability. Accordingly, the parties spend additional resources on ex-ante valuations of losses in order to draft the provision with reasonable damage estimates to make enforceability more likely in the event of a breach. [37]

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35. *See* Gerrit De Geest, *Penalty Clause and Liquidated Damages*, at 146.
36. *See Larry A. DiMatteo*, *Penalties as Rational Response to Bargaining Irrationality*, 2006 Mich. St. L. Rev. 883, 886, 910-911 (2006); *See also* Larry A. DiMatteo, *A Theory of Efficient Penalty: Eliminating the Law of Liquidated Damages*, 38 Am. Bus. L.J. 633, 668-75 (2001).
37. *See* Gerrit De Geest, at 146. (The accepted presumption is that ex-ante harm valuations are more costly than ex-post evaluations).

In terms of the costs of litigation, supporters of the penalty rule assert that a blanket application of the rule helps eliminate these costs since the underlying merits surrounding contractual disputes involving liquidated damages tend to be factual evaluations, which promote settlements. [38] In other words, parties disputing the legitimacy of a liquidated damages clause can easily evaluate their claims' strength as breach has likely occurred, and an ex post evaluation readily reveals whether the stipulated damages were reasonable estimates of actual harm; therefore, settlements – the preferred method of dispute resolution – are fostered. In addition, society also benefits from a blanket application as a reduction in penalty litigation prevents court congestion; moreover, as the rule is clearly established, less litigation alleviates society's burden of subsidizing the judicial process in these cases where no new beneficial precedent is formed. [39]

E. SPECIFIC PERFORMANCE & UNCONSCIONABILITY

Considering the rationales advanced in support of the penalty rule in terms of what may be best for society in general or the judicial process, it's beneficial to evaluate the policy relationships the rule shares with other doctrines known for limiting the freedom to contract. When reviewing the scholarship pertaining to the penalty rule in liquidated damages clauses, two legal doctrines known for restricting contractual freedom are frequently referenced – specific performance and unconscionability. An analysis of the underlying rationales justifying these doctrines reveals substantial similarities interwoven between all three doctrines. Most strikingly, the remedial justifications for enforcing the penalty rule are actually a combination of the other two doctrines, which seems logical considering most rules related to contract law are predicated on fairness and economic efficiency.

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38. *See* Paul H. Rubin, *Unenforceable Contracts: Penalty Clauses and Specific Performance*, Journal of Legal Studies, 237 Vol. 10 237, 244-245 (1981).
39. *See Id.* at 244, 246.

First, like unconscionability, the main rationale for the penalty rule is *fairness*; historically, the penalty rule derived from fraud and evolved alongside the earliest concepts of unconscionability. [40] Even now, the rule's economic justification is premised upon the just compensation principle, a concept synonymous with fairness – it would be 'unjust' to receive compensation for breach of contract beyond the harm actually suffered. Second, the penalty rule mirrors the justifications underlying the specific performance doctrine. Here, as a punitive measure, a court *only* grants injunctive relief for breach of contract when damages are an insufficient remedy, such as immeasurable or unique goods ; this is analogous to the efficient breach standard as driven by the compensatory goal of contract remedies. [41] As with the penalty rule, courts seek to deter inefficient specific performance when damages provide sufficient compensation for the harm suffered. [42] Like the expectancy limit, this maximized efficiency by allowing human performance to flow to its highest values, like any other commercial resource.

Accordingly, the policy relationship between these three doctrines are obviously grounded in terms of economic efficiency and fairness principles; however, as will be discussed in Part III, applying the penalty rule in ideally negotiated contracts is illogical and leads to results, which are significantly incongruent with these principles.

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40. "The oldest, and still most frequently advanced, argument against the enforcement of penalty clauses is simply that they are unfair or unconscionable… [G]enerally, penalty clauses often result from abuses of the bargaining process, such as oppression, duress, or fraud… [T]o allow the recovery of damages in excess of actual loss is simply contrary to basic principles of justice." Phillip R. Kaplan, *A Critique of the Penalty Limitation on Liquidated Damages*, 50 S. Cal. L. Rev. 1055, 1070 (1978); *See also* Corbin, *Contracts* §§ 1056, 1057 (1964).

41. "Specific performance or an injunction will not be ordered if damages would be adequate to protect the expectation interest of the injured party." Restatement (Second) of Contracts § 359 (1) Effect of Adequacy of Damages (1981); "In general, therefore, a party may find it advantageous to refuse to perform a contract if he will still have a net gain after he has fully compensated the injured party for the resulting loss." *Id*, intro note to ch. 16.

42. Efficient contractual remedies, such as specific performance, should deter breaches of contracts worth performing and avoid excessive performance, which generates no net benefits. *See* L. A. Kornhauser, *An Introduction to the Economic Analysis of Contract Remedies*, 57 U. of Colo. L. Rev. 683, 725 (1986).

III. JUSTIFICATIONS TO MODIFY THE PENALTY RULE

Whether due to perceived inefficiencies, wasted resources and other costs, or the innate realities of our legal system, there seems to be justifiable disadvantages associated with enforceable penalty clauses, which evidently counteract the benefits inherent in all freely negotiated contracts. However, relative differences existing between various parties' to a contract can modify the evaluation substantially. For example, a liquidated damages clause will carry vastly dissimilar contextual implications in contracts negotiated between large corporations as compared to those negotiated between parties with disparate to little sophistication levels or bargaining power.

Considering this dynamic, analyzing the following question seems to provide the most cogent assessment of the penalty rule's legitimacy as currently applied: do the efficiency gains and other advantages obtained by enforcing a penalty clause ever *outweigh* the costs and detriments avoided by a court striking it down? In other words, when if ever, should an otherwise illegitimate penalty clause be enforced? This seems to be the ultimate issue. [43] Obviously, as it relates to this discussion's central argument, this question will be addressed by analyzing the total utility, economic efficiency, externalities, overall fairness, and the policy implications in relation to enforcing the penalty clauses contained in *ideally negotiated contracts*. To begin, we must first reassess the remedial repercussions of invalidating these clauses, and determine whether the traditional conceptions of compensatory damages actually provide adequate compensation in this context.

43. Ideally, the rules of contract law, when tested in competitive market should encourage exchanges that maximize utility. *See* Richard Posner, *Economic Analysis of Law*, note 8 at pg. 44 (1972); "The purpose of contract law is to deter only those potential breaches which are inefficient. It is therefore necessary to *balance* the costs of inefficient breach against those of excessive performance. In this way, resources are encouraged to flow to their highest valued uses." Veljanovski, *Economic Principles of Law*, 109, 126 (Cambridge University Press, New York 2007).

A. REMEDIES REVISITED & UNDER-COMPENSATION

As discussed, the fundamental basis for invalidating penalty clauses from an economic perspective derives from an assumption that a party's expectation interest sufficiently measured the value of performance as anticipated under the contract. [44] However, this view fails to account for the subjective aspects or risk assumptions underlying the contract, which may fundamentally alter the actual 'value' the party placed on performance as negotiated. For example awarding damages predicated on an expectancy limit prevents parties from receiving compensation for idiosyncratic harm – harm that is unique or subjective to one party, which is only measurable by that party considering the contractual circumstances. To appreciate the concept of idiosyncratic harm, consider the implications of risk shifting in contract formation in the following *simplified* example:

> Suppose a Football Fan has a ticket to watch his favorite team play in the Super Bowl; however, the game is being played 100 miles away and he needs a ride to get there. It just so happens that a Football Fan's friend, Dependable is willing to drive him to the game in return for $500 – the market price for this service. Because Football Fan is incredibly desperate to watch the game, he wants to make sure Dependable will honor their arrangement. Accordingly, they contract and include a liquidated damages clause specifying damages of $3000 if Dependable fails to perform, which unfortunately for Football Fan, he does after deciding to watch a movie instead. To add insult to injury, after litigating the dispute, Football Fan's only recovery is $500 – his expectation interest – after the court invalidated the liquidated damages clause as an impermissible penalty. [45]

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44. "Contract damages are ordinarily based on the injured party's expectation interest and are intended to give him the benefit of his bargain by awarding him a sum of money that will, to the extent possible, put him in as good a position as he would have been in had the contract been performed." Restatement (Second) of Contracts § 347, Measure of Damages in General, cmt. a (1981); "For most contracts there is no absolute enforcement of a promise, only the payment of expectation damages, which gives the non-breaching party the benefit of the contract." Veljanovski, *Economic Principles of Law*, at 109.

45. *See* Goetz, Charles J. and Scott, Robert E., 77 Colum. L. Rev. 554 at 578. (Adaptation of similar hypothetical). Obviously, this hypothetical is used as a simple demonstration of the principle, but take note, this discussion contemplates larger more complex and expensive transactions, where the idiosyncratic losses are more substantial.

This situation elucidates the problem: the compensatory standard for contractual remedies doesn't recognize such subjective harms when measuring a party's expectancy interest. This is exactly the reason parties to contract desire the inclusion of liquidated damages provisions in their contracts – to avoid being the under-compensation inherent in traditional contract remedies.[46] As becomes clear, when a penalty clause is invalidated after a contract breach, any idiosyncratic losses suffered by the non-breaching party are excluded from the remedy, which necessarily leads to under-compensation in the damages awarded. [47]

Obviously, there are costs that remain uncompensated after a contract is breached regardless of the existence of a penalty clause, such as litigation costs and attorneys' fees. However, the standard compensatory measure for contract remedies further under-compensates the non-breacher when invalidating penalty clauses because the 'wasted' resources and transaction costs of forming such clauses as discussed in **Part II,** are also uncompensated losses.

Considering the problems with unaccounted for idiosyncratic losses, and resources utilized to negotiate and form contracts, which remain uncompensated using the compensatory model, there are strong justifications for providing the damage compensation the parties originally agreed upon in a penalty clause. This is readily apparent in penalty clauses provided in ideally negotiated contracts, especially considering that each party measures the

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46. Enforcement of liquidated damages agreements would permit parties to a contract to correct for the risk of systematic under-compensation provided by the conventional remedies for breach. Phillip R. Kaplan, *A Critique of the Penalty Limitation on Liquidated Damages*, 50 S. Cal. L. Rev. 1055, 1058 (1978); The inclusion of a penalty provision may be considered as a form of insurance from the breaching party to the innocent party. 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. *See* Goetz, Charles J. and Scott, Robert E., 77 Colum. L. Rev. 554 at 579; *See also* Robert Cooter & Thomas Ulen, *Law and Economics,* 295 note 12 at 293 (1988).

47. "[I]n some cases, the value of performance to the non-breaching party will be highly idiosyncratic, and the non-breaching party's assertion that performance was worth a great deal to him simply cannot be contradicted." William S. Dodge, 48 Duke L. J. 4, 629 at 674.

considerations of implementing the provision with sophistication and care at formation, and ultimately, made a voluntary decision that including the provision would be mutually beneficial. Although the enforcement of penalty clauses would technically exceed the non-breaching party with expectation interest, and therefore, award a punitive measure, doing so would necessarily obviate the under-compensation problems by upholding the parties' bargain as originally intended. [48] However, as discussed, the compensatory measure for contractual damages is promoted because it effectuates efficient breaches, whereas a punitive award deters such efficiency. Accordingly, as the general nature of efficiency is ultimately the primary objective within classical contract theory, our discussion must evaluate the merits of the penalty rule within the context of ideally negotiated contracts.

B. EFFICIENT BREACH?

In Part II, we discussed the apparent contradiction between the efficient breach and freely negotiated contracts. Efficient breach provides some efficiency, but it does not maximize efficiency as does enforcing contracts as originally formed under the freedom of contract principles discussed in **Part I** and it isn't the most efficient way to avoid inefficient performance.

First off, oldest and most fundamental cornerstones of classical contract theory, from the economic perspective, dictates that rational parties necessarily form mutually beneficial contracts that maximize efficiency because otherwise, the agreement *would not* have formed. This principle easily translates to penalty clauses in ideally negotiated contracts. Accordingly, when a

48. "There are now sound theoretical reasons for believing that liquidated damages-and other forms of stipulated remedy-should be routinely enforced by the court, even if they appear to contain a punitive element." Robert Cooter & Thomas Ulen, at 294; "A party who has voluntarily entered into a contract is bound by its terms, even though the contract may prove to be unwise or disadvantageous to him or her the courts are obligated to uphold even improvident, oppressive, hard, or bad bargains." 7 C.J.S. Contracts § 2, Nature, grounds, and validity of contractual obligation (2011).

penalty clause is invalidated after a breach, we must recognize that the total net utility as provided under the original contract is almost always reduced; remember, all the efficiency gains provided by the penalty clause were predicated on allocations of risk reflected by idiosyncratic harms – the entire reason for creating the clause. This conclusion follows logically considering any breach will be considered 'efficient' as long as the breaching party increases his financial position, even marginally, despite all the potential losses, which don't have to be reimbursed in order to compensate the non-breacher's expectation interest. This seems to counter the argument that efficient breaches are always efficient since the net loss is rarely offset in a way equaling the parties' combined utility under the original contract. This is true unless the breaching party somehow compensates *all* the non-breacher's losses or if somehow the efficiency gained by the breaching party exceeds both parties' original combined utility, both of which, are unlikely and counter the principles of what constitutes an efficient bargain. [49]

Additionally, allowing a party to breach contract and pay only expectation damages isn't the most efficient way to avoid an inefficient performance by enforcing the penalty. Instead of a blanket invalidation of penalties, a rule that provides for negotiation and a release of the obligation might be more efficient. If the party owing the penalty and is facing the prospect of inefficient performance, he could seek a release from the penalty, which would likely be granted as long as the release yields more value than the inefficient performance – the gain from breaching – and is less costly than the overall loss, which is prevented by the penalty. [50]

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49. Economic efficiency results from a "bargain from which both parties benefit resulting in a gain by moving the exchanged assets to higher valued uses. *See* Restatement (Second) of Contracts, intro. note to ch. 16 (1981).
50. Richard Posner, *Economic Analysis of Law*, 131 note 4, at 146 (5th ed. 1998).

C. EFFICIENCY REVISITED

There are additional reasons why the invalidation of penalty clauses create inefficiencies. Principally, since highly sophisticated parties are fully aware of the penalty rule's negative consequences, many of the welfare-increasing deals that would have otherwise been achieved are avoided; the resulting decrease in beneficial commercial activity, necessarily prevents an allocation of various resources at their highest values, and thus, decreases overall economic efficiency. [51] For example, suppose two large corporations, one standing to incur substantial idiosyncratic harm, forgo a mutually beneficial contract because they can't appropriately allocate risks without including a penalty clause. In this situation, the contract was averted because a highly sophisticated corporation understands that the necessary penalty clause would likely be invalidated and it wouldn't recover the idiosyncratic losses with a standard contract remedy. [52]

Penalties also have an efficient signaling effect; consider the following as proposed by the court in the XCO Intern. Inc. v. Pacific Scientific Co case:

> "[There is a] worthwhile effect of a penalty as a signal that the party subject to it is likely to perform his contract promise. This makes him a more attractive contract partner, since if he doesn't perform he will be punished severely. His

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51. "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."* Goetz, Charles J. and Scott, Robert E., 77 Colum. L. Rev. 554 at 583.(*emphasis added*); [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." *Lake River Corp. v. Carborumdum Co*., 769 F.2d 1284, 1289 (7th. Cir. 1985).

52. "Scholars tend to argue that penalty non-enforcement is both inconvenient and grossly inefficient, since stipulating damages may be the only way parties can signal the quality of their goods, screen their trading partners, or provide efficient insurance for 'idiosyncratic' tastes." Eric L. Talley, *Contract Renegotiation, Mechanism Design, and the Liquidated Damages Rule,* Stan. L. Rev. 46 No. 5, 1195, 1196 (1994); "In the absence of evidence of unfairness or other bargaining abnormalities, efficiency would be maximized by the enforcement of the agreed allocation of risks embodied in a liquidated damages clause." Goetz, Charles J. and Scott, Robert E., 77 Colum. L. Rev. 554, 578 (1977).

> willingness to assume that risk signals his confidence that he will be able to perform and thus avoid the penalty. It makes him a credible person to do business with, and thus promotes commerce." [53]

Furthermore, liquidated damages clauses by their very nature provide information regarding the magnitude of the potential loss, which provides useful information to parties regarding whether breaching would be efficient or not; this information allows these decision to be made quickly and rationally, and therefore, leads to efficiency by optimizing breach prevention costs. [54]

D. PERVERSE INCENTIVES OR OPPORTUNISTIC BREACH?

Proponents for the penalty rule point to the perverse incentives, which are caused by such clauses, but considering ideally negotiated contracts, this problem seems unpersuasive since sophisticated parties have likely factored the risks of breach inducing activities into their contract's terms. [55] The greater concern comes from a risk of opportunistic breach – "those in which the breaching party attempts to get more than originally bargained at the expense of the non-breaching party." [56] This seems to be exactly the case in some 'efficient breaches' followed by the invalidation of a penalty clause as any financial gains received are necessarily at the other party's expense considering the clause was inserted as protection against losses not recoverable through normal contract remedies. This becomes almost unconscionable considering that such 'efficiency' gains don't have to be proportional to the non-breacher's losses. For example, breach is encouraged even when the gain is $1 and loss is $10,000 – a situation arising where the

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53. *XCO Intern. Inc. v. Pacific Scientific Co*, 369 F.3d 998 at 1001.

54. *See* Gerrit De Geest, *Penalty Clause and Liquidated Damages* at 146.

55. "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." Anthony T. Kronman & Richard A. Posner eds., *The Economics of Contract Law*, note 4 at 224.

56. William S. Dodge, 48 Duke L. J. 4 at 632; see also *See Patton v. Mid-Continent Sys*., 841 F.2d 742, 751 (Providing that opportunistic breaches occur when the "the promisor wants the benefit of the bargain without bearing the agreed-upon cost." *See Patton v. Mid-Continent Sys*., 841 F.2d 742, 751 (7th Cir.1988).

idiosyncratic loss exceeds the expectation interest by $10,000. Such results seem counterintuitive considering the penalty rule is predicated on fairness. In Judge Posner's words, when a party breaches opportunistically, "we might as well throw the book at the [him]" and "such conduct has no economic justification and ought simply to be deterred." [57]

E. TRANSACTION & LITIGATION COSTS

As mentioned in **Part II**, advocates for the penalty rule defend the position by presuming the rule avoids excessive transaction and litigation costs. However, creating liquidated damages provisions can reduce expenses. Consider the following regarding transaction costs:

> "In terms of cost savings, well-drafted penalty clauses have beneficial effects for front-end transaction costs. A default rule that penalty clauses are presumed enforceable will allow parties to negotiate more freely such clauses. This would save costs of negotiating around the current rule and negotiating other types of clauses that go to timely performance or remedies and would also reduce the need to seek out more expensive third-party protection (insurance)." [58]

Regarding litigation costs, proponents for the rule asserted that it prevents litigation costs, which benefit everyone by reducing these litigated disputes; however, it's equally justified to claim enforcing penalty clauses in ideally negotiated contracts provides the same result.

> The costs and inconvenience of litigation should be factored into the enforceability decision. The penalty clause, if enforced under liquidated damages law, acts as an alternative dispute resolution device. Thus, the scope of acceptability of the penalty amount should be broadened to reflect the dispute resolution cost savings to the parties and the external costs savings to the court system. This leads back to the foundational law and economic principle that parties are more efficient in negotiating their own contract terms than courts are in devising and supplying default rules. [59]

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57. Richard A. Posner, *Economic Analysis of Law*, note 4 at 130; "[T]he fundamental function of contract law (and recognized as such at least since Hobbes's day) is to deter people from behaving opportunistically toward their contracting parties." *Id* at 103.

58. *Larry A. DiMatteo*, *Penalties as Rational Response to Bargaining Irrationality*, 2006 Mich. St. L. Rev. 883, 911 (2006).

59. *See Id.* at 912; See also Phillip R. Kaplan, 50 S. Cal. L. Rev. 1055 at 1057.

F. PATERNALISTIC POLICY

There's an answer to Judge Posner's so-called "unexplained puzzle" regarding the penalty doctrine – it's simply paternalistic. This is especially true as applied to ideally negotiated contracts between parties such as large corporations that form contracts fully expecting their transaction to be mutually beneficial and value maximizing. The penalty doctrine by its very nature is a clear constraint on contractual freedom and considering other doctrines like unconscionability already in place, various legal and economic scholars proclaim the doctrine simply an archaic relic of judicial paternalism. [60]

Considering the policy rationales advanced in support of unconscionability and specific performance in **Part II** there seems to be severe incongruence with the law's unwillingness to allow punitive damages for contractual breaches by invalidating penalties; these two doctrines are predicated on fairness and efficiency, yet the penalty rule seemingly produces unfair and inefficient results when applied to ideally negotiated contracts. Evidently, there is a lapse of reasoning when applying the rule in this context. Unsurprisingly, the policy similarities between the specific performance, unconscionability, and penalty doctrines provide a basis to allow punitive damages for contract breaches with penalty clauses, which rectifies this incongruence.

60. "It seems odd that courts should display parental solicitude for large corporations." *Lake River Corp. v. Carborundum Co*., 769 F.2d 1284 at 1289; "The implications of the penalty doctrine are anomalous in terms of the theoretical underpinnings of modem contract law" Goetz, Charles J. and Scott, Robert E., 77 Colum. L. Rev. 554 at 555; "In sum, contemporary cost-benefit analysis suggests that the traditional penalty rule is anachronistic for several reasons: (1) the efficiency costs of the rule are now apparent in the light of modern analysis; (2) the market imperfections 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." *Id* at 594; "Of the three paternalistic limitations we have considered, the prohibition on penal clauses is both the most important, from a practical point of view, and the least defensible from an economic point of view-or any other." Anthony T. Kronman & Richard Posner, *The Economics of Contract Law*, note 1 at 261; "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." *Id.* note 4 at 224.

As discussed the motivation behind enforcing specific performance and penalty clauses arises from the compensatory nature of remedies, which seeks to prevent inefficient performance by encouraging efficient breach by recognizing only the expectation interest for contract breaches. However, considering that mandatory injunctions – a punitive remedy equating to specific performance of a contract – are sometimes justified when the value of performance is hard to measure or *unique* and the traditional remedy is insufficient, likewise, a penalty clause should also be enforced in ideally negotiated contracts using the same logic. As discussed, the reason parties desire penalty clauses is to allocate risks and insure against subjective idiosyncratic losses by securing performance, which by its very nature is hard to measure and unique; furthermore, traditional remedies for such losses are under compensatory and insufficient. Accordingly, as both specific performance and the penalty rule are regulated by the overarching doctrine of Unconscionability to ensure fairness in contractual dealings, why should one form of punitive damage be allowed for contract breach but not the other – especially as between highly sophisticated entities like corporations? Apparently, the scholars are right: the penalty doctrine, in this context is merely paternalistic, inefficient, and unjustified.

CONCLUSION

The penalty rule doctrine is overbroad and needs to be modified; it should not apply to ideally negotiated contracts. The basis for the rule is grounded in terms of fairness and efficiency, but applied in this context it contradicts its own justifications. Additionally, the negative consequences generated by the rule's application are achieved by dismissing contractual freedom, the fundamental keystone of contract theory and economic welfare generally. Ultimately, there is no rational basis for the penalty rule as applied in these situations, and despite its long acceptance in American Jurisprudence, it deserves significant reevaluation.