

**Punitive Damages, Liquidated Damages, and *Clauses Penale* in Contract Actions:
A Comparative Analysis of the American Common Law and the French *Code Civil****

*by Charles Calleros***

***Abstract** – Although American common law allows punitive damages for reckless or intentional torts, it will neither allow a jury to assess punitive damages for breach of contract nor permit enforcement of a contractual damages clause that is deemed to be punitive. This approach is rooted in an early Chancery practice of granting equitable relief from oppressive penal bonds and has been more recently justified as a means of facilitating efficient breach. Economic efficiency, however, can be accomplished even if punitive damages could be assessed for intentional breach, because the parties would have an incentive to negotiate a release from the first contract to enable both to share in the surplus offered by an intervening contractual opportunity. Moreover, negotiation of an enforceable penalty clause would allow some parties to maximize their utility by exchanging a signal of assurance of performance for a premium fee. Additionally, the French experience invites a fresh look, because – although it generally disallows punitive damages of a judicial origin for any civil wrong, tort or breach of contract -- it honors freedom of contract and the autonomy of the parties by enforcing a contractual penalty clause (although the court may reduce an excessive contractual penalty). Taking a cue from the French approach, American courts and legislatures should reconsider their refusal to sanction freely negotiated penalty clauses and enforce them to the extent that they permit the parties to maximize their collective utility.*

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Although the United States is infamous for headline-grabbing punitive damages awards in tort actions, most jurisdictions in the United States adhere to the traditional common law rule against punitive damages for breach of contract, if the breach neither constitutes nor is

accompanied by tortious conduct. This hostility to punitive damages in contract actions extends to (or perhaps originates in) contractual liquidated damages clauses, which courts in the United States will not enforce if they are deemed to be punitive rather than compensatory. In contrast, even though the French Civil Code limits judicial awards to compensatory damages in tort actions as well as those in contract, it specifically requires enforcement of *clauses penale*, even if – as the term *penale* suggests – they are designed to compel the breaching party to pay extra-compensatory damages. Although amendments to the code authorize judges to reduce grossly excessive penalty clauses, the code permits a punitive element to remain.

This article joins several other commentators in questioning the rule against judicial punitive damage awards for intentional breaches of contract, at least in those cases in which the breach is not efficient. More centrally, taking a cue from the French Civil Code, this article proposes enforcement of freely negotiated stipulated damages clauses for intentional breaches of contract, even if the clause is both prospectively and retrospectively punitive in nature.

I. Punitive Damages and Liquidated Damages in the United States

A. Legal Rules and Tests

Juries in the United States have discretion¹ under the common law to award punitive

¹ *E.g.*, *Smith v. Wade*, 461 U.S. 30, 52 (1983) (referring to jury’s “discretionary moral judgment” in describing general common law tort principles applicable to remedies under 42 U.S.C. § 1983 (2000)).

damages for egregiously tortious conduct, defined in most states as a tort committed with at least reckless disregard for the rights of others.² Some statutes also authorize awards of punitive damages, either open-ended or as a multiplier of actual damages.³ Although awards of punitive damages in tort actions are not as ubiquitous, excessive, and unjustified as they are often portrayed in popular culture,⁴ and though they are subject to constitutional limitations imposed by due process,⁵ they nonetheless hold out the possibility of total recovery that greatly exceeds

2 See William S. Dodge, *The Case for Punitive Damages in Contracts*, 48 Duke L.J. 629, 689 & nn.325-27 (1999) (stating general standard, collecting cases, and noting that gross negligence will also suffice in a few states); see also 42 U.S.C. § 1981a (2000) (requiring proof of “malice or reckless indifference to . . . federally protected rights” for punitive damages for violations of Title VII of the 1964 Civil Rights Act); *Smith v. Wade*, 461 U.S. at 37-51 (reviewing historical development of federal and state tort law, and requiring proof of intentional violations of federal law or “reckless or callous disregard for the plaintiff’s rights” for punitive damages for violations of 42 U.S.C. § 1983).

3 See, e.g., 42 U.S.C. § 1981a (2000) (authorizing punitive damages, subject to caps, for disparate-treatment violations of Title VII of the 1964 Civil Rights Act, if the plaintiff has no right of action under 42 U.S.C. § 1981 (2000)); *Smith v. Wade*, 461 U.S. at 35 (punitive damages are available for constitutional torts under 42 U.S.C. § 1983 (2000)); John Gotanda, *Supplemental Damages in Private International Law* 195 and n.3 (1998) (discussing statutory punitive damages in the form of multiples of compensatory damages, and citing to RICO statute as example of one that imposes treble damages).

4 See Patrick S. Ryan, *Revisiting the United States Application of Punitive Damages: Separating Myth From Reality*, 10 ILSA J. Int’l & Comp. L. 69 (2003) (lamenting the urban legends and other inaccuracies about U.S. tort law and punitive damage awards that are circulated even by academics in Europe); Theodore Eisenberg, *John M. Olin Program in Law and Economics Conference on “Tort Reform”: The Predictability of Punitive Damages*, 26 J. Leg. Stud. 623, 634 (1997) (noting that punitive damages were awarded in only about 3% of tort cases in a study, with a modest median punitive damage award of \$50,000, contrary to the popular perception, which is influenced by a few very large awards).

5 *BMW of N. Amer. v. Gore*, 116 U.S. 559 (1986) (state award of punitive damages violated

the amount needed to compensate the plaintiff for actual injury.⁶

All but a handful of states,⁷ however, follow some version of the traditional common law rule denying punitive damages for breach of contract, subject only to a few exceptions. Under the traditional rule, punitive damages are not available for even a deliberate breach of contract,⁸

due process by considering the defendant's activities outside the jurisdiction, by permitting punitive damages 500 times greater than compensatory damages, and by failing to give adequate notice of the possibility of such liability); *Pacific Mutual Life Ins. Co. v. Haslip*, 517 U.S. 559 (1996) (requiring, among other things, meaningful judicial review of jury awards of punitive damages). In 2003, the Supreme Court stated that due process does not impose a strict limit on the ratio of punitive damages to compensatory damages, but it hinted in dictum that a single-digit ratio is safest. *State Farm Mutual Automobile Ins. Co. v. Campbell*, 538 U.S. 408 (2003). In a case vacated by the Supreme Court for reconsideration in light of *Campbell*, the Oregon Supreme Court applied the standards of *Gore* and *Campbell* and approved a punitive damages award far beyond a single-digit ratio for particularly outrageous tortious conduct. *Williams v. Philip Morris, Inc.*, 127 P.3d 1165 (Or. 2006).

6 *See, e.g., Williams, supra* note 5, 127 P.3d at 1171, 1181-82 (approving punitive damages of approximately 97 times the amount of compensatory damages awarded by the jury, or 159 times the amount of compensatory damages as capped by the trial court); *Mathias v. Accor Economy Lodging, Inc. and Motel 6 Operating L.P.*, 347 F.2d 672 (7th Cir.2003) (approving punitive damages amounting to more than 37 times the amount of compensatory damages).

7 A few states permit punitive damages for any breach of contract that is accomplished with a certain level of culpability or that is accompanied by certain tortious elements, regardless whether all the elements of an independent tort have been pleaded and proved. *E.g., Vernon Fire & Casualty Ins. Co. v. Sharp*, 349 N.E.2d 173, 180 (Ind. 1976) (allowing punitive damages whenever "elements of fraud, malice, gross negligence or oppression mingle" with the contract breach, regardless whether an independent tort is established) (quoting *Taber v. Hutson*, 5 Ind. 332, 334 (1854)); *Wright v. Pub. Sav. Life Ins. Co.*, 204 S.E.2d 57, 59 (S.C. 1974) (allowing punitive damages for "the breach of a contract, committed with fraudulent intent, and accompanied by a fraudulent act"); *Bank of New Mexico v. Rice*, 429 P.2d 368 (N.M. 1967) (permitting punitive damages for a malicious breach of contract, or one that reflects a wanton disregard of the other party's rights).

8 *See, e.g., Thyssen Inc. v. S.S. Fortune Star*, 777 F.2d 57, 62-63 (2d Cir. 1985) (identifying this

with the possible exceptions of a breach of promise to marry; a public service company's breach of contract that also constitutes breach of a duty otherwise owed by law to the public; or a breach of contract that also constitutes, or is accompanied by, either a breach of fiduciary duty or a tort for which punitive damages are recoverable.⁹

In recent decades, courts in many states have authorized punitive damages for “bad faith” breaches of the implied contractual duty of good faith and fair dealing,¹⁰ at least in certain kinds

standard as a general rule in the United States); *White v. Benkowski*, 155 N.W.2d 74 (Wis. 1974) (absent independent basis for punitive damages in tort, holding that punitive damages were not available for breach of a water supply contract, even though the jury found that the breaching parties had maliciously cut off the flow of water to the other parties for the purpose of harassing them).

9 Henry Mather, *Contract Law and Morality* 117-18 (1999); Dodge, *supra* note 2, at 636 (1999); *see, e.g.*, *Brown v. Coates*, 253 F.2d 36, 39 (1958) (approving punitive damages for an agent's flagrant and intentional contract breach constituting a breach of fiduciary duty to his principal). The final exception – stated in section 355 of the Restatement (Second) of Contracts as breach of contract that “is also a tort for which punitive damages are recoverable” – appears to state the obvious. After all, if the plaintiff pleads and proves a tort that independently supports an award of punitive damages, why would the plaintiff need a contractual basis for punitive damages? This exception might still be meaningful if some states allow an award of punitive damages when the evidence showing breach of contract also establishes an egregious tort, even though only the contract claim is properly before the jury for procedural reasons. *Cf. Brown*, 235 F.2d at 39 (punitive damages may be awarded for a calculated, flagrant contract breach in disregard of obligations of trust when it “merges with, and assumes the character of, a willful tort”).

10 *See Comunale v. Traders and General Ins. Co.*, 328 P.2d 198 (Cal. 1958) (seminal decision holding that an insurer's breach of an implied covenant of good faith and fair dealing sounds in tort as well as contract, thus opening up the possibility of tort recovery, including punitive damages); W. David Slawson, *Binding Promises* 74-80, 104-116, 131-32 (1996) (discussing “relational torts,” “bad faith breach,” and justifications for punitive damages); Dodge, *supra* note 2, at 637-44 (discussing expansion of this doctrine in the 1970's and 1980's, followed by partial retraction beginning in 1988).

of contractual relationships.¹¹ This development, however, should not be viewed as a widespread expansion of exceptions to the traditional contracts rule, because most courts following this trend have recognized the breaching parties' conduct to be tortious,¹² providing an independent basis for punitive damages.¹³ Alternatively, bad-faith breach in the context of certain special

11 Courts in some states, for example, limit punitive damages for breach of an implied duty of good faith and fair dealing to "bad faith breaches" of duties in insurance contracts. *E.g.*, *American Health Care Providers, Inc. v. O'Brien*, 886 S.W.2d 588, 590 (Ark. 1994). Others extend such treatment to a broader class of contracts involving "special relationships" with attributes similar to that between an insurer and insured. *E.g.*, *Rawlins v. Apodaca*, 726 P.2d 565 (Ariz. 1986) (referring to contractual relationships implicating the public interest, giving rise to fiduciary responsibilities, or raising problems of adhesion).

12 *See* Slawson, *supra* note 10, at 122 (Although parties "ought not to be liable for punitive damages merely for breaching a contract . . . [b]ad faith breach is a tort, not a mere breach of contract."). With respect to courts that awarded punitive damages for bad faith breach without recognizing it as a tort, some of them had already liberalized their law of contract remedies to permit punitive damages for egregious contract breaches. *See, e.g.*, *Romero v. Mervyn's*, 784 P.2d 992, 998 (N.M. 1989) (stating that punitive damages for bad faith breach in an insurance contract were available on the relaxed basis of gross negligence or recklessness, but noting that punitive damages had long been available for breaches of other kinds of contracts, on a showing that the breaching party acted at least "recklessly with a wanton disregard for the plaintiff's rights").

13 Of course, if the courts characterized the breach of the implied duty as a tort solely to make punitive damages available for a particularly troublesome type of contract breach, then the "tort" label may draw no more than a semantic distinction, and the authority to award punitive damages for this breach ought to be viewed as an expansion of contract remedies. *See generally* Dodge, *supra* note 2, 637-38 (referring to punitive damages for breach of the duty of good faith and fair dealing as an "expansion of punitive damages for breach of contract," regardless whether characterized as contract or tort claims); Mather, *supra* note 9, at 132 n.24 ("Rather than tempt courts to invent new torts, . . . it would be preferable to say that certain breaches of contract call for punitive damages, regardless of whether such breaches are tortious."). Professor David Slawson, however, argues convincingly that the tort classification in the bad-faith cases reflects a finding that the defendant's conduct does more than breach the private contractual obligations owed to the other party; it also violates community standards, causing injury to the public.

relationships can be viewed as a breach of fiduciary duty, falling within one of the traditional exceptions.¹⁴ Moreover, the trend of awarding punitive damages in this context eventually reached a plateau and even retreated in some states.¹⁵

The antipathy in the United States toward punitive damages in contracts cases extends to a claim based on a liquidated damages clause to which the parties agreed in their contract.¹⁶ In general, courts in the United States will not enforce such clauses if they are designed to impose a penalty for breaching the contract, rather than to fix compensatory damages at a reasonable estimate of actual injury.¹⁷ The traditional common law test in the U.S. is a prospective one:

Slawson, *supra* note 10, at 90-96, 115. The same can be said for other torts that arise out of a contractual relationship, such as wrongful discharge in violation of public policy. *See id.* at 80-81 (briefly summarizing the history of this claim and criticizing cases that find the public policy violation to constitute solely a breach of an implied contractual obligation rather than a tort). These torts, then, provide grounds for punitive damages independent of any contract claim, even though they arise out of a contractual relationship.

14 *See, e.g., Romero*, 784 P.2d at 998 n.3; Bruce Chapman and Michael Trebilcock, *Punitive Damages: Divergence in Search of a Rationale*, 40 Alabama L. Rev. 741, 767-68 (1989) (speculating that intentional breach of fiduciary duty might explain the “increasing number of American punitive damages cases in the context of insurance contracts”).

15 *See Dodge*, *supra* note 9, at 642-43 (describing the effects of a “backlash” against punitive damages); Slawson, *supra* note 10, at 110-12 (describing retrenchment in California jurisprudence).

16 Indeed, the historical basis for the common law’s rejection of punitive damages for breach of contract may be traced to penalty bonds, a form of contractual penalty clause. *See infra* at notes 29-36 and accompanying text.

17 *E.g., Wasserman’s, Inc. v. Township of Middletown*, 645 A.2d 100, 109 (1994); U.C.C. § 2-718(1) (1998) (in transactions in goods, “A term fixing unreasonably large liquidated damages is void as a penalty”); Restatement (Second) of Contracts § 356 (1981) (under the common law, “[a] term fixing unreasonably large liquidated damages is unenforceable on grounds of public

courts will enforce a liquidated damages clause if, at the time of contracting, the liquidated damages represent a reasonable estimate of the damages that would flow from a breach, taking into consideration the difficulty in calculating damages in the event of a breach or the difficulty of estimating the damages in advance.¹⁸

Under the modern trend, the liquidated damages may be upheld if they are reasonable in light of either the anticipated injury, viewed prospectively, or the actual injury caused by breach, viewed retrospectively.¹⁹ A retrospective test, however, generally will not be used to *defeat* a liquidated damages clause: If the liquidated damages clearly represent a reasonable estimate of actual injury in light of information available at the time of contracting, they will be upheld by most courts even though the actual injury caused by breach is unexpectedly low or even non-existent.²⁰ Still, a great disparity between the liquidated damages and the actual harm suffered by

policy as a penalty.”).

18 *See Wasserman's*, 645 A.2d at 105-07 (tracing history, summarizing policy considerations, and synthesizing authorities); *see also* U.C.C. § 2-718(1) (1998) (for a transaction in goods, assessing a liquidated damages clause on the basis of its reasonableness in light of the “harm caused by the breach, the difficulties of proof of loss, and the inconvenience or nonfeasibility of otherwise obtaining an adequate remedy”).

19 *See Wasserman's*, 645 A.2d at 107; U.C.C. § 2-718(1) (1998) (judging reasonableness in light of either the “anticipated or actual harm”); Restatement (Second) of Contracts § 356(1) (1981) (same). It is unlikely that this second bite at the apple, however, will greatly increase the number of liquidated damages clauses that are upheld. The additional retrospective branch of the test would rescue a clause only if the parties’ estimate was unreasonably large in light of information available at the time of contracting, suggesting an intent to impose a penalty for breach, but the actual harm turns out to be greater than could be anticipated, so that the inflated estimate in fact corresponds reasonably to the actual damages suffered.

20 *See, e.g.*, Joseph M. Perillo, CALAMARI AND PERILLO ON CONTRACTS § 14.31(c), at 592 (5th

breach may help raise doubts about the integrity of the parties' estimate and may lead to particularly careful scrutiny of the clause under the prospective test.²¹ At bottom, the court must determine whether the evidence suggests that the parties, at the time of contracting, were less concerned with fixing uncertain damages than with compelling performance with an *in terrorem* penalty clause.

B. Historical Roots and Policy Justifications in the Common Law

1. Historical Dichotomy between Torts and Contracts

Early references to extracompensatory damages appear in the Code of Hammurabi²² and the Old Testament,²³ but the first award of punitive damages in the common law is attributed to the Eighteenth Century English case of *Wilkes v. Wood*, as part of the damages awarded for a warrantless search.²⁴ Professor John Gotanda surmises that separate awards for punitive damages in appropriate cases grew out of an earlier judicial deference to extracompensatory jury

ed. 2003); *Keep the Change: A Critique of the no Actual Injury Defense to Liquidated Damages*, Wash. L. Rev. 977 (Oct. 1990) (critiquing minority view that reasonable liquidated damages clause is not enforceable if the victim of breach in fact suffers no injury).

21 *See generally Wasserman's*, 645 A.2d at 107 (citing to sources suggesting that hindsight may influence application of a purportedly prospective test, including to *Wassener v. Panos*, 331 N.W.2d 357, 364 (Wisc. 1983)).

22 *See Gotanda, supra* note 3, at 194 & n.2.

23 *See id.*; *White v. Benkowski*, 155 N.W.2d 74, 76 (Wis. 1967) (quoting Exodus 22:1 for the mandate that a wrongdoer “shall restore five oxen for an ox, and four sheep for a sheep”).

24 98 Eng. Rep. 489 (C.B. 1763) (discussed in Gotanda, *supra* note 3, at 196).

awards disguised as compensatory damages for nonpecuniary injury.²⁵

In the wake of *Wilkes v. Wood*, English courts allowed punitive damages for a wide variety of tort actions, but withheld them in actions on contractual undertakings.²⁶ Even as England limited punitive damages more narrowly to a few categories of cases for four decades in the latter half the Twentieth Century,²⁷ courts in the United States continued to embrace the dichotomy of early English common law, granting punitive damages for a wide variety of tortious conduct, if committed intentionally or recklessly, but generally denying them for breach of contract.²⁸

Ironically, the English common law rule against punitive damages for breach of contract may have originated with judicial and legislative antipathy to a clever form of liquidated damages clause, the conditional bond.²⁹ In such a bond, a debtor, for a fee, would make a bond to pay a certain sum of money to the creditor, which bond would be discharged if the debtor timely completed some other performance, such as constructing a bridge, which was the true object of

25 Gotanda, *supra* note 3, at 200-01.

26 *See id.* at 195-96.

27 *See id.* at 197-98; Andrew Tettenborn, *Punitive Damages – A View from England*, 41 San Diego L. Rev. 1551, 1551-56 (2004). .

28 *See supra* at notes 1-15 and accompanying text.

29 *See* Charles J. Goetz & Robert E. Scott, *Liquidated Damages, Penalties and the Just Compensation Principles: Some Notes on an Enforcement Model and a Theory of Efficient Breach*, 77 Colum. L. Rev. 554, 554 (1977), *cited in* Wasserman's, 645 A.2d at 105.

the transaction.³⁰ Framing the construction obligation in this manner allowed the creditor to enforce the obligation in an action on debt, which brought certain procedural advantages over an action for breach of covenant; moreover, as with any form of liquidated damages, the fixed debt eliminated uncertainty about the damages that might be awarded for failure to construct the bridge in an action in covenant.³¹

The creditor in a conditional bond normally had sufficient bargaining power to introduce a punitive element, so that the sum conditionally owed by the debtor could significantly exceed the cost or value of the alternative performance (in this example, constructing the bridge) or of any damages that the creditor likely would suffer from the failure of the obligor to render the alternative performance.³² The punitive element of a conditional bond was most obvious if the alternative performance, the true object of the transaction, was itself the payment of money by a certain date. Failure to render that performance and thus discharge the bond would result in an obligation on the bond to pay a much higher amount, typically double the amount needed to discharge the bond.³³

During the Fourteenth and Fifteenth centuries, the device of the conditional bond was widely used and was generally enforced, with little regard for the penalties that they frequently

30 See D.J. Ibbetson, *A HISTORICAL INTRODUCTION TO THE LAW OF OBLIGATIONS* 29 (1999).

31 *Id.* at 28-30.

32 See *id.* at 29.

33 *Id.* at 30.

imposed.³⁴ During the Sixteenth Century, however, the Chancery developed a practice of granting equitable relief from judgments at law enforcing punitive conditional bonds, if the debtor had innocently failed to discharge the bond and if he promptly completed the necessary performance and paid damages for any remaining actual injury.³⁵ In 1697, this equity approach was extended by statute to actions at law, at least for conditional bonds with obvious penalties, thus eliminating the need for a two-step process of securing a full judgment at law on the bond and then adjusting the relief in a separate action in equity.³⁶

Thus, by the time English courts began awarding punitive damages in 1763 in tort actions,³⁷ a tradition against penalties in contract actions was well-established. The historical dichotomy in the common law between tort and contract in the availability of punitive damages, however, still begs the policy question: Why did Chancery find that punitive conditional bonds violated principles of equity, a reaction later echoed by Parliament just 70 years before the advent of punitive damage awards in common law actions in tort? More to the point, because the rule against punitive damages in contract actions in the United States is defended now on grounds of public policy rather than purely as an historical holdover from English law, what are the policies

³⁴ *Id.* at 28-29 and n.23.

³⁵ *Id.* at 29 n. 23, 213-14.

³⁶ *Id.* at 214; *see also* Restatement (Second) of Contracts § 356(2) (1981) (as a matter of contemporary U.S. common law, declaring a conditional bond to be unenforceable on grounds of public policy to the extent that it imposes a penalty for non-occurrence of the condition of the bond).

³⁷ *See supra* note 24 and accompanying text.

that support the rule, and do they justify withholding punitive damages across the board for all contract breaches and withholding enforcement of all penalty clauses? In exploring the policy justifications for the general rule against punitive damages in contract actions, it may be impossible to fully separate post-hoc policy arguments from those that may have motivated early hostility to penalty clauses in the common law legal system.³⁸ A brief survey of the leading arguments, however, will inform a comparative analysis of the French approach.

2. Policy Justifications for the Rule Against Punitive Damages and Against Enforcing Penalty Clauses

Unlike civil law jurisdictions, common law jurisdictions within United States cannot justify the contract rule against punitive damage awards on the ground that punishment should be reserved for the criminal justice system with its elevated burden of proof and other procedural protections.³⁹ In contrast to, for example, the French Civil Code,⁴⁰ U.S. common law permits punitive damages in civil actions in tort,⁴¹ using the same general civil procedures and burdens of proof as would apply for any civil claim, including one for breach of contract.⁴²

38 Cf. Dodge, *supra* note 2, at 630 & n.3 (in note 3, quoting Timothy J. Sullivan, *Punitive Damages in the Law of Contract: The Reality and the Illusion of Legal Change*, 61 Minn. L. Rev. 207, 221 (1977) (other than simple adoption of the traditional English rule, the reasons for the U.S. contract rule against punitive damages are unclear).

39 See Gotanda, *supra* note 3, at 193.

40 See *infra* Section II.

41 See *supra* notes 1-6 and accompanying text.

42 True, the power to impose punitive damages outside the restrictions of the criminal justice

One might attempt to explain the difference in availability of punitive damages between tort and contract actions in the United States on the basis of the source of the obligation in each type of action. While tort duties are based on community standards of conduct,⁴³ contractual obligations are, for the most part,⁴⁴ created and defined by the parties.⁴⁵ It may be plausible to assume that parties normally do not intend to create mutual obligations that place themselves at risk of paying an uncertain amount of punitive damages in the event of breach. This assumption, however, might not hold true for all breaches. If they addressed the question, some parties might favor the availability of punitive damages for reckless or intentional breaches, particularly if each could not envision acting with such culpability himself. That the contract rule against punitive damages is based on broader public policy concerns, and not simply on generalizations

system “increases concerns” in the American judiciary about the administration of punitive damages. *State Farm Mutual Automobile Ins. Co. v. Campbell*, 538 U.S. 408, 417 (2003). Accordingly, punitive damage awards are subject to constitutional review for possible violations of due process, *see supra* note 5, and the constitutional imperative to police punitive damage awards in turn mandates effective review procedures, *see Cooper Indus. v. Leatherman Tool Group, Inc.*, 532 U.S. 424 (2001) (engaging in unrestricted review of the mixed question of law and fact of whether a jury’s award of punitive damages comports with due process). These due process restrictions on punitive damages, however, would apply equally to punitive damages awarded for breach of contract, and they do not import the full range of safeguards for which our criminal system is known.

43 Patrick J. Kelley, *SYMPOSIUM: Restating Duty, Breach, and Proximate Cause in Negligence Law: Descriptive Theory and the Rule of Law*, 54 *Vand. L. Rev.* 1039, 1063 (2001).

44 Of course, the parties’ agreement is subject to judicial interpretation, *see* Restatement (Second) of Contracts §§ 201-04 (1981), to judicial trimming of provisions that are unconscionable or that violate public policy, *see, e.g., id.* at §§ 178, 208, 356, and to the addition of legally implied obligations, such as the obligation of good faith and fair dealing, *id.* at § 205.

45 E. Allan Farnsworth, *CONTRACTS* 4-5 (3d ed. 1998).

about the intentions of the parties, is shown by the inability of the parties to draft around the rule. Penalty clauses, even though voluntarily adopted by the parties, are unenforceable.⁴⁶

Our efforts to explain the different treatment of contracts and torts in the common law system likely will bear more fruit if we begin with the goals or purposes of punitive damages and then examine the extent to which the contract rule against punitive damages is consistent with those goals or purposes and with policies underlying contract law.

As underscored by the frequent characterization of punitive damages as “exemplary damages,”⁴⁷ the primary purpose of punitive damage awards is to supplement compensatory damages as a means of deterring future reckless or intentional torts.⁴⁸ Secondly, punitive damages serve a broad retributive purpose, allowing the jury to express the community’s outrage at egregiously wrongful conduct by imposing punishment that the wrongdoer deserves and by providing the victim of the wrongdoing with a sense of satisfaction that justice has been done,⁴⁹

46 *See supra* note 16-21 and accompanying text.

47 Slawson, *supra* note 10, at 122.

48 Mather, *supra* note 9, at 117.

49 Slawson, *supra* note 10, at 122 (referring to retribution that gives the defendant “his just deserts,” thus both “vindicat[ing] the public values against which the wrongdoer offended” and “assuag[ing] the suffering of the injured party”). “In the retributive view, the justification of any punishment is backward-looking and desert-based rather than forward-looking and consequentialist.” Chapman and Trebilcock, *supra* note 12, at 780. The secondary nature of the retributive purpose of punitive damages is underscored by Professor Mather: “Punishment is not justified when it is purely retributive,” but should “serve beneficial purposes.” Mather, *supra* note 9, at 118-19. *But cf.* Chapman and Trebilcock, *supra* note 12, at 780 (discussing Kantian view that retribution should be the primary goal of punishment, without constraints induced by other benefits that might flow from punishment or from abandoning or reducing it).

or perhaps providing the victim with a sense of satisfaction that may come with exacting revenge on the wrongdoer.⁵⁰ They also supplement compensatory damages as a means of substituting for, and thus discouraging, violent or otherwise antisocial self-help remedies.⁵¹ Finally, an award of punitive damages may help to cure any deficiency in the compensatory damage award's redress of all injuries, as well as to pay for the costs of litigation.⁵²

The final two purposes of punitive damages described above need not detain us long.

The goal of discouraging self-help remedies does not explain the tort/contract dichotomy,

50 Studies suggest that humans have an evolved tendency to punish others within their group who act unfairly or uncooperatively in the pooling or distribution of resources, even if the punishment would further reduce resources immediately available to the punishing party. Karl Sigmund, Ernst Fehr and Martin A. Nowak, "The Economics of Fair Play," *Scientific American* (Jan. 2002), pp. 83-87 (referring to "an ambitious cross-cultural study," to variations of an "ultimatum game" studied by economists, to an evolutionary model studied by authors Sigmund and Noak and by Karen M. Page, and to experiments conducted by author Fehr and Simon Gächter). Early humans who acted this way may simply have possessed a tendency to feel satisfaction in exacting revenge on those who shortchanged them, a sense of satisfaction that outweighed the immediate economic cost of exacting the revenge. *Id.* at 86-87 ("revenge is sweet"). Humans possessing that tendency, in turn, likely developed a reputation in the community that discouraged unfair behavior toward them in the future, thus increasing the chances that they would survive, thrive, reproduce, and pass their vengeful genes to offspring. *See id.* at 85-86. In other cases, their actions may have served to maintain discipline and cooperation in a group whose solidarity is threatened by external forces, thus increasing the possibility that the entire group will survive. *Id.* at 87. Interestingly, although the punishing parties may have acted solely in response to an emotional desire to exact revenge, rather than in response to a conscious calculation of the long-term effects of their actions, *id.*, an evolutionary observer should conclude that the vengeful actions incidentally served the policy of deterring others from directing unfair actions toward the punishing party in the future or of deterring anti-social behavior that threatens the entire group. Thus, a retributive desire for revenge may ultimately serve the goal of deterrence.

51 Gotanda, *supra* note 3, at 195.

52 *Id.*

because egregious breaches of contract, as well as egregious torts, presumably would increase pressures for self-help in the absence of adequate damages. Compensatory damages likely will be sufficient to discourage extralegal self-help in the case of a tort or contract breach of low culpability that causes less offense to the other party; conversely, some residual pressure for self-help likely will remain in the absence of punitive damages in the case of either a tort or contract breach that provides great offense to the other party, such as conduct taken with a malicious intent to harm.

At first blush, the final purpose of redressing deficiencies in non-punitive awards might support the rule permitting punitive damages in tort actions but not contract actions, because tort plaintiffs generally must pay attorneys' fees out of their own pockets or damage awards, whereas prevailing parties in contracts actions will frequently receive an award of reasonable attorneys' fees, either by statutory authorization⁵³ or by provision of the contract being enforced. Unless the means for calculating punitive damages⁵⁴ were changed, however, punitive damage awards would provide an exceedingly crude and imprecise means of financing costs of litigation. Moreover, punitive damage awards should not be employed as a covert means of correcting deficiencies in compensatory damages or addressing runaway costs in our adversary system. Such problems, to the extent they exist and can be redressed, should be addressed more directly.

53 *E.g.*, Ariz. Rev. Stat. § 12-341.01 (2003).

54 *See, e.g., Kirkbride v. Lisbon Contractors, Inc.*, 555 A. 2d 800, 803 (1989) (using factors listed in Restatement of Torts § 908(2) for assessment of punitive damages, such as the character of the act, the extent of the harm, and the wealth of the defendant).

Thus, even this cursory inquiry shows that the third and fourth goals of punitive damages are inadequate to explain the tort/contract dichotomy in U.S. law. The goals of retribution and deterrence, however, raise some interesting questions, warranting fuller discussion.

a. Retribution

If a reckless or deliberate breach of contract does more than disappoint the expectations of the other party, if it constitutes a moral wrong or otherwise injures the public by offending community values, then the breaching party may deserve to be punished – and the community, through the jury, may be justified in expressing its disapproval – with extracompensatory damages. If so, then this retributive purpose of punitive damages would also be served by judicially enforcing a penalty clause if its application is limited to breaches reflecting a requisite degree of culpability.

On the other hand, the retributive purpose for punitive damages awards can be consistent with the current practice of awarding punitive damages for reckless or intentional torts, and not for similarly culpable breaches of contract, if such breaches of contract are viewed as less blameworthy than their counterparts in tort. Justice Holmes guaranteed himself a place at the table for any discussion of this issue with his widely quoted remarks about the nature of contractual obligations: “The duty to keep a contract at common law means a prediction that you must pay damages if you do not keep it – and nothing else.”⁵⁵ Accordingly, “[t]he only universal consequence of a legally binding promise is, that the law makes the promisor pay damages if the

⁵⁵ Oliver Wendell Homes, Jr., *The Path of the Law*, 10 Harv. L. Rev. 457, 462 (1897).

promised event does not come to pass. In every case it leaves him free from interference until the time for fulfilment has gone by, and therefore free to break his contract if he chooses.”⁵⁶

All will agree that purely innocent breaches, such as ones arising from nonculpable oversight, miscalculation, or inability to accomplish the promised task despite best efforts, do not merit retributive punishment beyond compensatory damages.⁵⁷ On their faces, however, Justice Holmes’s statements appear to support the argument that even a deliberate breach of contract is not a moral or legal wrong but instead is a legitimate option open to the obligor, who may exercise that option by paying compensatory damages, measured by expectation interest, in lieu of performance.⁵⁸

Professor Joseph Perillo has argued that Holmes’s statements have been misinterpreted and that Holmes’s private correspondence and utterances from the bench suggest that he would characterize contract breaches as wrongful conduct, on the same plane as tortious conduct.⁵⁹ Aside from the intended meaning of Holmes’s remarks, others have argued that at least some

56 Oliver Wendell Holmes, Jr., *THE COMMON LAW* 301 (1881).

57 *See, e.g.,* Mather, *supra* note 9, at 119 (arguing that unavoidable or negligent breaches, or ones that are the product of misinterpretation of the contract, are insufficiently blameworthy to justify punitive damages).

58 *See also* Slawson, *supra* note 10, at 122 (persons who breach contracts “have done nothing wrong if they pay full compensation”).

59 Joseph M. Perillo, *Misreading Oliver Wendell Holmes on Efficient Breach and Tortious Interference*, 68 *Fordham L. Rev.* 1085, 1085-87 (2000).

kinds of breaches reflect moral fault.⁶⁰

One can hardly deny that some breaches are more morally blameworthy than others: an innocent oversight that leads to installation of the wrong brand of pipe⁶¹ reflects less culpability than a malicious breach of contract committed for the purpose of harming the other party.⁶² The ultimate question is whether contract remedies should distinguish between these levels of culpability or should leave notions of fault out of the equation.

Some have justified the denial of punitive damages for breach of contract by noting that contract liability, unlike most tort liability, is not fault-based.⁶³ This assertion, however, is subject to critique. True, if a promisor undertakes to achieve a certain result, rather than merely to exercise a certain degree of skill or effort, her failure to achieve that result will constitute

60 *E.g.*, Mather, *supra* note 9, at 118-19 (arguing that contract remedies should be depend on the degree of moral fault, justifying punitive damages for intentional breach of contract).

61 *See* Jacob & Youngs v. Kent, 129 N.E. 889 (N.Y. 1921) (majority finding that “the omission of the prescribed brand of pipe was neither fraudulent nor willful,” but the result of “inattention and oversight”).

62 *See* White v. Benkowski, 155 N.W.2d 74 (Wis. 1974) (jury found that the breaching parties had maliciously cut off the flow of water to the other parties for the purpose of harassing them). In *White*, evidence submitted at trial tended to show an escalating series of personal squabbles between the parties, who were neighbors, prior to the malicious breach of contract. *See* Robert A. Hillman, *Enriching Case Reports*, 44 St. Louis U.L.J. 1197, 1201 (2000) (quoting from *Robert S. Summers & Robert A. Hillman, Contract and Related Obligation* 17 (3d ed. 1997)).

63 *E.g.*, Mather, *supra* note 9, at 117 (rule against punitive damages is partly based on traditional rule that “the remedy for breach of contract should not depend on the degree of fault of the breaching party”).

breach of contract, regardless of her degree of effort, skill, good faith, and conscientiousness,⁶⁴ subject only to limited legal excuses such as supervening impossibility.⁶⁵ Conceding that breach may be found on the basis of strict liability, however, does not answer the question whether retributive goals might yet be vindicated by awarding differing levels of recovery for breaches that reflect different degrees of culpability.

Thus, one might reasonably ask whether some highly culpable breaches of contract would sufficiently offend community values as to justify retribution in the form of punitive damages. Professor Henry Mather would find “damage to social trust and to the practice of contracting,” and would award punitive damages, in the case of any “clearly knowing and intentional breach” of contract, subject only to a narrow exception for breaches that were compelled by the need to perform a “higher moral duty to a third person,” such as deliberately failing to pay a phone bill

64 *See, e.g.*, *Patton v. Mid-Continent Systems, Inc.*, 841 F.2d 742, 750 (7th Cir. 1988). A finding that the breach was “innocent,” “unintentional,” or in “good faith, rather than “willful,” however, may combine with other factors to help show that the breach was minor, rather than material, and that it thus satisfied constructive conditions for counter-performance. *See, e.g.*, *Walker & Co. v. Harrison*, 81 N.W.2d 352, 355 (Mich. 1957) (quoting Restatement (First) of Contracts § 275 (1932), subsection (e) of which refers to the “wilful, negligent or innocent behavior” of the breaching party as relevant to the determination of material breach); *Jacob & Youngs v. Kent*, 129 N.E. 889, 891 (N.Y. 1921) (stating that the “willful transgressor,” unlike one whose “default is unintentional and trivial,” has “no occasion to mitigate the rigor of implied conditions); Restatement (Second) of Contracts § 241(e) (relevant to determination of materiality of breach is “the extent to which the behavior” of the breaching party “comports with standards of good faith and fair dealing”).

65 *See, e.g.*, Restatement (Second) of Contracts § 261 (1981) (“Discharge by Supervening Impracticability”).

on time so that hungry children can be fed.⁶⁶

Not all intentional breaches, however, warrant punishment to satisfy the plaintiff's and the community's desire for retribution. Retribution may provide partial justification for punishing a defendant who has maliciously breached for the purpose of harassing the plaintiff,⁶⁷ or perhaps one who has intentionally breached in an attempt to reallocate from the plaintiff to himself a greater proportion of a fixed amount of resources.⁶⁸ Community values, on the other hand, may not be offended by even intentional breaches that are "efficient" in the sense that they serve to increase total wealth, rather than diminish or selfishly reallocate existing wealth.⁶⁹

Professor Mather reached his conclusions favoring punitive damages for intentional breaches of contract after rejecting efficient breach arguments.⁷⁰ The arguments grounded in economic efficiency, however, merit further discussion in the context of the deterrence goals of

66 Mather, *supra* note 9, at 119 (arguing also that punitive damages for such breaches satisfy a deterrence function and would educate the public that performing contracts "is an important community norm"); *see also* Slawson, *supra* note 10, at 123 (punitive damages would promote a private attorney general function by "encouraging people to identify and punish those who are guilty of civil wrongdoing").

67 *See, e.g., supra* at note 50.

68 *See* Dodge, *supra* note 2, at 652-57 (arguing for punitive damages for such breaches, which author characterizes as "willful" breaches that are "opportunistic" rather than efficient).

69 *See id.* at 663 (even a deliberate breach "is not necessarily blameworthy" if supported by efficiency concerns) (quoting Judge Richard A. Posner in *Patton v. Mid-Continent Sys.*, 841 F.2d 742, 750 (7th Cir. 1988)); Slawson, *supra* note 10, at 122 (People who breach contracts "have done nothing wrong if they pay full compensation. Indeed society loses if people do *not* breach contracts that would cost them more to perform than to pay compensation for breaching.").

70 Mather, *supra* note 9, at 118.

punitive damages.

b. Deterrence

If the time for contract performance has not passed, and if the victim of a repudiation can overcome the significant hurdles to the extraordinary and discretionary equitable remedy of specific performance,⁷¹ a court can deter further breach of that contract in a most direct manner by issuing an injunction compelling performance.⁷² In the typical case, however, specific relief will be unavailable for practical or legal reasons,⁷³ and the threat of liability for damages will serve as the main legal deterrent to breach. Although the prospect of paying compensatory damages for a civil wrong has deterrent value,⁷⁴ the risk of liability for a potentially much larger award of punitive damages presumably enhances the deterrence considerably.

With assistance from the efficient breach doctrine, the policy of deterrence may help to explain the tort/contract dichotomy in the availability of punitive damages in the United States. Because reckless or intentional torts by their very nature offend community values, and because they often cause their victims to suffer significant physical or emotional injuries, legal rules that

71 See, e.g., E. Allan Farnsworth, *Legal Remedies for Breach of Contract*, 70 Colum. L. Rev. 1145, 1151-56 (1970).

72 Specific relief would not necessarily serve a retributive purpose, nor would it necessarily deter other parties in the future as surely as would the availability of punitive damages. Its primary effect would be to prevent breach, or further breach, in the case at hand.

73 See generally Stephen A. Smith, CONTRACT THEORY 398-408 (2004) (critically examining explanations for the common law's reluctance to grant the "secondary remedy" of specific performance).

74 See, e.g., Dan B. Dobbs, THE LAW OF TORTS 17 (2001).

tend to deter such conduct, such as the availability of punitive damage awards, are viewed as appropriate in the common law system.⁷⁵ The efficient breach doctrine, on the other hand, argues that some kinds of contract breaches will benefit the community and should be permitted, or even encouraged, rather than deterred with extracompensatory damages.⁷⁶

The most easily defended efficient breach is one that achieves Pareto optimality by leaving some entities better off because of the breach while leaving no party in a worse position than if the contract had been performed.⁷⁷ For an illustration, suppose that Pierce Construction Co. of Desert City is hired to excavate the site for a new parking garage at Mercado Shopping Center, with a completion date of August 1, earning the owner an estimated \$20,000 in profit after payment of materials, labor, and other expenses. After Pierce bound itself to Uptown but before commencement of performance, Upstart Development Co. received the final permits and financing needed to begin construction on an upscale boutique shopping center on the edge of the city, around a picturesque array of huge boulders. Anxious to break ground immediately, and recognizing that Pierce was uniquely qualified to perform the complicated grading and

⁷⁵ See generally Smith, *supra* note 73, at 419 (contrasting the seriousness of a physical assault with even a deliberate breach of contract that causes only pecuniary harm, particularly when the deliberately breaching party does not compound the breach by then denying liability).

⁷⁶ See, e.g., Richard A. Posner, *ECONOMIC ANALYSIS OF LAW* 142 (5th ed. 1998); Dodge, *supra* note 2, at 631-32 & nn. 6-9 (citing to sources that promote the efficient breach argument).

⁷⁷ See Dodge, *supra* note 2, at 652-53 (explaining difference between Pareto efficiency, in which breach causes some to be better off and no one to be worse off, and Kaldor-Hicks efficiency, in which breach increases total wealth but the victim of the breach may be worse off for the breach); Perillo, *supra* note 55, at 1091-92 & n.40 (same).

excavation around the boulders, Upstart offered Pierce a lucrative contract to perform that work, which would earn Pierce an estimated \$60,000 profit. Pierce, however, did not have the capacity to complete both the Mercado contract and the Upstart project by August 1, and Upstart remained firm on the completion date, fearing that any delay would disrupt parking during the onset of the holiday shopping season in early November. If Pierce repudiated the Mercado contract, Mercado could hire another perfectly well qualified contractor to perform its rather routine excavation, but only at a fee of \$10,000 above Pierce's fee under the original contract because of extra costs associated with the short notice, causing Mercado to suffer \$10,000 in damages.

In these circumstances, the community would benefit if Pierce breached the contract with Mercado, voluntarily paid (or was compelled to pay) \$10,000 in compensatory damages to Mercado, and reallocated its resources to the Upstart project. With the \$10,000 in damages, Mercado would realize its expectation of securing timely and competent excavation without expending any more of its own resources than it had originally bargained to pay Pierce. Indeed, because contract remedies thus protect the expectation interest of the victim of breach, Mercado theoretically should be "*indifferent* between performance and breach."⁷⁸ In turn, having abandoned the Mercado contract, Pierce would have the opportunity to put its unique capabilities to full use in a new project that will boost its profits by \$40,000, for a net gain of \$30,000 additional profits after paying \$10,000 in compensation to Mercado. Theoretically, Mercado is no worse off than if Pierce had performed its contract, Pierce is better off for having breached

78 Robert Cooter and Thomas Ulen, LAW AND ECONOMICS 226 (3d ed. 2000).

that contract, and the greater income to Pierce and the advancement of the Upstart project likely will have further multiplier effects on the local economy.

Pierce will have an economic incentive to breach his contract with Mercado if he is confident that, in a suit by Mercado to secure damages for Pierce's breach of contract, a court would award only Mercado's compensatory damages in the amount of Mercado's expectation interest, \$10,000 in this case. If the law instead would permit a jury to award additional and substantial punitive damages for Pierce's intentional breach, Pierce would face the risk of total liability that exceeded the additional profit earned on the Upstart project, and Pierce likely would turn down the Upstart project to avoid that risk.

In sum, according to the efficient breach theory, the welfare of the community will be enhanced if the law does not permit the threat of punitive damages to deter parties in Pierce's position from breaching. By extension, concerns about efficient allocation of resources would also support a rule that denies enforcement of contract clauses that go beyond liquidating compensatory damages and that contemplate penalties large enough to deter efficient breaches.⁷⁹

79 Because Pierce's performance, once provided to Mercado, cannot then be transferred to Upstart, economic efficiency would also support a court's exercising discretion to refrain from ordering specific performance of Pierce's obligation to Mercado. *See id.* at 240 Smith, *supra* note 70, at 405 (explaining that efficiency theory supports the status of specific performance as a secondary remedy in common law systems); *but cf.* Cooter and Ulen, *supra* note 78, at 238-44 (whether and to what extent specific performance reduces efficiency when the value of resources are reordered depends on the nature of the performance and on transaction costs). One scholar argues that specific performance should be more widely granted because setting awards of money damages presents uncertainties in valuation, which in turn complicates settlement negotiations and increases transaction costs. Thomas Ulen, *The Efficiency fo Specific Performance: Toward a Unified Theory of Contract Remedies*, 83 Mich. L. Rev. 341, 365-66 (1984). Regardless whether

Although the efficient breach theory is the dominant contemporary justification offered for the unavailability of punitive damages for contract breaches, it has attracted criticism on a number of grounds. Most obviously, not all breaches are economically efficient. The suppliers of water in *White v. Benkowski* breached the water supply contract not to reallocate the water resources to a more valuable use,⁸⁰ but to maliciously harass the other parties, with whom the suppliers had been embroiled in an escalating series of personal squabbles.⁸¹ In other cases, a party might breach a contract in an effort to gain a greater share of fixed resources in a zero-sum game with the other party, without increasing the size of the economic pie.⁸² In either case, unlike an efficient breach, the breach disappoints expectations without increasing total wealth. If such cases could be easily distinguished from efficient breaches, and if parties contemplating breach could accurately predict whether their breaches would be deemed to fall outside the category of efficient breaches, the threat of punitive damages for inefficient breaches could

specific enforcement is widely or only rarely granted, it would not necessarily prevent efficient allocation of resources, because an efficiently breaching party can always seek to persuade the other party to release it from contractual obligations by offering to share a substantial proportion of the increased profits to be earned in the new enterprise. *Cf. infra* note 87 and accompanying text (making similar point about the effect of awarding punitive damages for intentional breach of contract).

80 One could assert such a purpose if the jury had believed that the Benkowskis had shut off the Whites' water supply for the purpose of conserving that scarce resource for a use more valuable than that of fulfilling the contract with the Whites. However, the jury found otherwise. *See White v. Benkowski*, 155 N.W.2d 74, 75 (Wis. 1974).

81 *See supra* note 62.

82 *See* Posner, *supra* note 76, at 130; Dodge, *supra* note 2, at 652-53 (discussing Posner's views on such "opportunistic breaches").

provide deterrence without offending the efficient breach doctrine.

In addition, some commentators reject the efficient breach doctrine even as applied to breaches that economists would define to be Pareto efficient. These critics argue that the victim of breach is in fact worse off for the breach because payment of compensatory damages as defined by applicable legal standards will not fully compensate the victim for all losses caused by the breach;⁸³ that few breachers, efficient or otherwise, voluntarily offer to pay compensation, often causing victims of the breach to take less than is due to them to avoid litigation costs;⁸⁴ that the efficient breach doctrine fails to account for and internalize the social costs and harm to community values engendered by breach of contract;⁸⁵ that failing to allow for punitive damages will encourage deliberate breaches that are inefficient because the breaching party is apt to overestimate the gains to be earned by breach and to underestimate the losses suffered by the victim of the breach;⁸⁶ and that allowing punitive damages for deliberate breach will not discourage efficient breaches but will simply force efficient breachers to negotiate a release in exchange for a share of the gain to be earned by breach.⁸⁷

83 *E.g.*, Perillo, *supra* note 59, at 1093-94; *see also infra* note 202.

84 *E.g.*, Dodge, *supra* note 2, at 664. This objection to efficient breach theory is partially vindicated by the willingness of courts to award punitive damages for bad faith breaches in some contexts. *See supra* notes 10-14 and accompanying text.

85 Mather, *supra* note 9, at 118.

86 *Id.*

87 Dodge, *supra* note 2, at 632-34, 665-99.

Indeed, as applied to enforcement of freely negotiated extracompensatory liquidated damages clauses, some argue that enforcing the penalty helps to realize other efficiencies by permitting parties to allocate their risks in a way that best meets their interests.⁸⁸ For example, suppose that a bride and groom have an intensely sentimental attachment to the five-piece swing band that performed at a local club the night they first danced together and fell in love. They greatly desire to hire the band to play at their wedding reception, but the bride and groom are terrified that the band might cancel and leave them scrambling for a substitute band or playing recorded music. The bride and groom will derive so much subjective benefit from the appearance of this band, and they will gain such peace of mind if they can secure special assurances of the band's performance, that they are happy to pay \$5,000 – double the band's normal rate of \$2,500 – if the band agrees to waive the right to that fee and to be liable for additional damages of \$6,000 in the event that it fails to perform at the appointed time and place. The bride and groom are willing to pay a premium for special assurance of performance, which we might cleverly call an “assurance of performance policy,” and which is more valuable to the bride and groom than insurance coverage from a third party, because – at least at the time of contracting – the bride and groom derive more value from the ability to compel performance than from the right to collect

88 *See, e.g.,* Lake River Corp. v. Carborundum Co., 769 F.2d 1284, 1289 (7th Cir. 1985) (dictum criticizing state common law rule that uniformly withholds enforcement of penalty clauses); Jürgen Noll, *Economic Implications of Contractual Penalties - Where Courts Go Wrong*, in TRENDS IN MACROECONOMIC RESEARCH 143, 150-160 (Lawrence Z. Pelzer ed., 2005).

money for nonperformance.⁸⁹

In turn, the band members are happy to agree to these terms, because they cannot foresee any event that would cause them to cancel their performance or even to arrive late, and they recognize that the penalty clause allows them to send a strong signal of their reliability, a signal for which the bride and groom are willing to pay a premium that is greatly valued by the impecunious members of the band.⁹⁰ Assuming that the damages clause, coupled with the band's waiver of the \$5,000 fee, exceeds any reasonable estimate of the actual damages that the bride and groom could recover under legal standards in their jurisdiction, it will be viewed as a penalty, designed to compel performance. If it were enforceable, the band likely would be induced to take extra precautions to avoid breach, such as avoiding situations in the days preceding the performance date that might cause band members to become seriously ill or injured or stranded at a faraway airport.⁹¹

89 Charles Goetz and Robert Scott, *Liquidated Damages Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model of Efficient Breach*, 77 Colum. L. Rev. 554, 578 (1977) (illustrating this point with their example of the Anxious Alumnus, an unusually loyal fan of his alma mater's basketball team, who is concerned that a bus carrying friends to an important college basketball game will not arrive on time or at all); Cooter and Ulen, *supra* note 75, at 236-37 (discussing the case of the Anxious Alumnus); Ugo Mattei, *Comparative Law and Economics* 179-81 (1997) (presenting his example of a bride's father who is anxious to ensure that a builder renovates a country house in time for the wedding, and who wants to ensure performance rather than simply collect money from a third-party insurer in the event of breach).

90 See Cooter and Ulen, *supra* note 78, at 237 (penalty clause may be cheapest way to "convey information about the promisor's reliability"); Posner, *supra* note 76, at 142.

91 Some argue that the threat of penalty for breach will induce precautions to a degree that is inefficient. *E.g.*, Samuel Rea, Jr., *Efficiency Implications of Penalties and Liquidated Damages*,

The common law rule against enforcing such a penalty clause deprives the bride and groom of the peace of mind for which they are willing to pay a premium, and it deprives the band members of the opportunity to double their pay in exchange for essentially surrendering the option of deliberately breaching – an option on which they placed little or no value – and for incurring the cost of taking reasonable precautions against unintentional breach. A rule that enforced such a clause would enhance efficiency by allowing the parties to increase their total utility.⁹²

Moreover, in the highly unlikely event that another client valued the band sufficiently to offer to pay the band \$10,000 to perform at the time and date of the wedding reception, the band would not be absolutely precluded from taking advantage of the new opportunity. Even though the \$6,000 net penalty exceeds the net benefits (an additional \$5,000 in earnings) to be derived from taking advantage of the new opportunity, the band could attempt to negotiate a release from the bride and groom, who would then have the opportunity to reassess the level of their desire for this band and to weigh it against other benefits that could be purchased with the settlement

13 J.L. Studies 147, 166 (1984). The party assuming the risk of penalty, however, presumably can assess the precautions appropriate to comfortably assure performance and can determine the increase in fee that will compensate for the additional precautions and residual risk. If the other party is willing to pay that premium, then the value placed on that assurance of performance by the other party outweighs the costs of taking precautions.

⁹² Of course, courts would need to police penalty clauses to ensure that they are not the products of overreaching. Judge Posner has suggested a rule that ordinarily enforces a penalty clause freely negotiated by a sophisticated party such as a “substantial corporation.” *Lake River Corp. v. Carborundum Co.*, 769 F.2d 1284, 1289 (7th Cir. 1985).

offered by the band.

True, the bride and groom set the penalty (over and above their withholding the band's \$5,000 fee) at the *in terrorem* level of \$6,000 for the purpose of compelling performance, and not because they prefer to collect the penalty, much less a smaller amount;⁹³ accordingly, they would not likely agree to a release on terms that made sense to the band. However, just as an intervening opportunity has altered the band's valuations, changes in the circumstances of the bride and groom might increase their willingness to negotiate. For example, suppose the wedding reception guest list unexpectedly expanded by twenty per cent after the bride and groom contracted with the band, with no additional funding from parents and other relatives available. In light of these changed circumstances and the great desire of the bride and groom to retain the quality of the food and drink that they plan to serve, the bride and groom might reluctantly accept the notion of hiring a substitute band if the contracted band agrees not only to forgo its fee of \$5,000 (more than sufficient to allow the bride and groom to hire a good substitute band) but also to pay an additional \$4,000 in damages, which the bride and groom desperately need to meet the new catering budget. Unless other considerations outweigh their expected net gain of \$1,000,⁹⁴

93 See Mattei, *supra* note 89, at 180 (explaining why the anxious father of the bride in his example prefers to compel performance over collecting money from a third-party insurer).

94 For example, nonpecuniary considerations might make the new offer less attractive than its fee suggests. The band members might be motivated to forgo the additional \$1,000 if they were acquainted with the bride and groom and would derive considerable psychic income from performing at the wedding reception, and if the alternative performance imposed psychic costs because it was a fundraiser for a cause that the band members abhor.

the band will be willing to agree to this settlement because obtaining a release from the contract permits it to increase its income by \$5,000 at a cost of paying \$4,000 in damages.

If, on the other hand, the circumstances of the bride and groom have not changed, and if they value performance more than an offered settlement of \$5,000 in waived fees and up to \$5,000 in additional damages, the band will not obtain a release. In that case, if the penalty clause were enforceable, the band would be forced to forgo the new opportunity even though the third party valued the band at \$10,000 and the wedding reception will pay only \$5,000, arguably an inefficient result. The supposed inefficiency, however, rests on acceptance of a measure of compensatory damages based on general market valuations. It may be that most wedding couples would suffer little damage if the contracted band canceled with ample notice, forgoing its fee, and allowing the wedding party to arrange a substitute transaction at perhaps a slightly higher fee to obtain a comparable band on shorter notice. However, if the bride and groom in this case rejected the band's offer to forgo its fee and to pay up to an additional \$5,000 in damages, the bride and groom apparently would have determined that their subjective injury exceeds the gains that the band could earn from breaching, so that the breach would not be efficient by those standards. Whether this more subjective valuation of damages should be honored is worth discussion and debate.

Moreover, although a rule enforcing the penalty clause, coupled with the bands's failure to obtain a release from its obligation, prevents the band from earning a higher fee, its position is similar to that of any party who feels regret after a change in the market. In this case, the band

voluntarily committed itself irrevocably to an attractive fee – double its normal rate – while gambling that a still more lucrative but conflicting opportunity would not later present itself. It had the option of insisting on a contract promising payment of its normal fee and with no more than the usual consequences for breach, but it found the opportunity to earn double the normal rate to be sufficiently attractive to place economic restrictions on its Holmesian option to breach and to pay standard expectation interest.⁹⁵

c. Summing Up but Suspending Judgment

A review of the arguments outlined above suggest that some kinds of contract breaches – such as a deliberate breach accomplished solely for the purpose of depriving the other party of contractual benefits, without increasing total wealth – merit retributive punishment and justify an award that will deter such breaches in the future. Purely innocent breaches do not merit retributive punishment; moreover, the risk of liability for compensatory damages should be sufficient to deter overly casual promising by those who lack the ability to perform, whereas the threat of extracompensatory damages could discourage bargaining between honest and able parties.⁹⁶ Between these extremes of the spectrum lie deliberate but efficient breaches, which promoters of the efficient breach doctrine would not punish, but for which Professor Dodge would award punitive damages in the hope of inducing the breaching part buy a release from the

⁹⁵ See *supra* notes 55 & 56 and accompanying text.

⁹⁶ Nicholas J. Johnson, *The Boundaries of Extracompensatory Relief for Abusive Breach of Contract*, 33 Conn. L. Rev. 181, 184 (2000).

victim of breach, using part of the gains from the efficient breach. Alternatively, a legal rule could award the more certain amount of the breaching party's gains from deliberate breach, once again providing an incentive for an efficiently breaching party to buy a release from the victim of the breach, who will motivate to sell a release to pave the way for a sharing of the additional profits in an alternative opportunity.

The efficient breach argument is often advanced to justify the historical tort/contract dichotomy in the common law, which excludes punitive damages for all breaches. However, because the goals and purposes of punitive damages are advanced by awards of extracompensatory damages for some kinds of breaches but not for others, public policy might be better vindicated with a more nuanced rule if the sheep can be separated from the goats. Because punitive damages are not a matter of right but are left to the discretion of the jury,⁹⁷ contract law could permit punitive damages in all cases – or in a broadly defined class of cases, such as deliberate breaches – and could leave it to the jury to assess whether a particular breach is sufficiently anti-social in the circumstances to merit retribution and deterrence. However, because common law rules regarding compensatory damages are designed to control jury discretion,⁹⁸ any tinkering with the general rule against punitive damages would most realistically take the form of a relatively bright-line rule that identifies certain kinds of breaches generally warranting punishment and deterrence, while still leaving discretion to the jury within

⁹⁷ *Supra* note 1.

⁹⁸ Perillo, *supra* note 20, § 14.5(a), at 568, § 14.8, at 574.

such categories to award or withhold punitive damages for such breaches, in light of the particular circumstances of the case.

Similarly, some kinds of penalty clauses might be consistent with the purposes and goals of punitive damages and with the policies underlying contract law; if so, and if the sheep again can be separated from the goats, a nuanced rule could permit enforcement of some penalty clauses though not others. For example, a rule that departs from the current common law approach might allow enforcement of a penalty clause that applies only to deliberate and inefficient breaches, but withhold enforcement of others. A more aggressive departure from the current rule might enforce penalties that applied even to efficient breaches – perhaps only if the penalty were limited to the gain to be realized from breach – on the ground that the parties likely would share the gain and negotiate a release from the contract. An even more radical rule might enforce all penalty clauses, subject only to policing for overreaching, on the ground that parties can adequately assess the premium that will make it worth their while to take extra precautions against breach.

All of these considerations, however, have been presented and evaluated in the context of a common law system that has traditionally singled out contract actions for its rule excluding punitive damages and has applied that rule across the board to liquidated damages clauses that are penal in nature. Before finally assessing the various arguments supporting and opposing the enforcement of penalty clauses in a common law jurisdiction, this article will now turn to the approach in the French civil law system, to determine whether the very different experiences and

traditions of a different legal system can provide any fresh insights.

II. Punitive Damages and Liquidated Damages under the French Civil Code

A. The French Civil Code and French Legal Method

As first of the original Napoleonic codes,⁹⁹ the French *Code Civil* is a leading example of codification that is designed to, or at least purports to, comprehensively set forth the law on designated topics,¹⁰⁰ in this case topics such as property, torts, contracts, and domestic relations.¹⁰¹ Some modern amendments to the *Code Civil*, such as Title V of the Third Book of the Code, relating to community property rights and other legal incidents of marriage, address its topic in great detail,¹⁰² in a manner similar to the style of legislation frequently seen in common law systems.¹⁰³ Much of the *Code Civil* however, remains largely unchanged since its enactment in 1804, when it was drafted in a simple, concise style.¹⁰⁴ This style of brevity and

99 John P. Dawson, *THE ORACLES OF THE LAW* 382 (1968).

100 See Eva Steiner, *FRENCH LEGAL METHOD* 29, 32 (2002).

101 See C. CIV., *Table Des Matières*, at 1943-57 (Daloz 101st ed. 2002) (table of contents of annotated French Civil Code); *THE FRENCH CIVIL CODE* vii-xvii (John H. Crabb, trans., rev. 1995) (“Analytical Summary” of French Civil Code, as translated into English).

102 See *id.* at art. 1387-1581.

103 See Steiner, *supra* note 100, at 18-20 (comparing the greater complexity of English drafting style with that of Continental code systems such as the French codes, but noting that some French legislation resembles the English style in verbosity and complexity).

104 See, e.g., C. CIV. art. 1382 - 1386 (Daloz 101st ed. 2002) (setting forth a body of tort law in five concise articles); Steiner *supra* note 100 at 15 (underscoring the brevity of articles 1382 - 1386, but noting that the code currently addresses selected contemporary topics of tort law with additional groupings of articles).

simplicity was influenced by the writings of Pothier, a judge and academic who sought to synthesize and simplify the chaotic mosaic of Roman Law, local and regional customary laws, and supplementary judicial doctrines that defined private law in France in the Eighteenth Century.¹⁰⁵

The exegetical school of thought, which dominated French legal method during the Nineteenth Century, advanced the view that the Napoleonic Codes were comprehensive and internally consistent.¹⁰⁶ This view supported techniques of statutory interpretation that sought to discover and give effect to the original intentions of the legislature that enacted the code provision in question.¹⁰⁷ The post-revolutionary judiciary, on the other hand, was constrained by a backlash against the pre-revolutionary high courts, the *Parlements*, which had grown over several centuries from a royal advisory council to a system of central and regional courts that sometimes exercised quasi-legislative powers in the form of regulations or decrees.¹⁰⁸ Corrupted by the sale of judicial offices and having earned a reputation for wielding excessive political and legal power, the *Parlements* were overthrown during the French revolution.¹⁰⁹ The post-revolutionary courts were prohibited by the Constituent Assembly of 1790 from issuing

105 See Dawson, *supra* note 99, at 349-50.

106 *Id.* at 393.

107 *Id.* at 394; Steiner, *supra* note 100, at 61.

108 Dawson, *supra* note 99, at 273-74, 306-14.

109 *Id.* at 350-71.

regulations or decrees,¹¹⁰ and in 1804 were prohibited by the *Code Civil* from announcing legal principles unrelated to the disputes before them.¹¹¹ Although such proscriptions might appear to do little more than restrict the publication and effect of dictum, which is not binding even in the United States,¹¹² these restrictions in fact combine with other facets of the legal system to challenge the very power of the courts to make any law at all.

The drafting and enactment of the apparently comprehensive Napoleonic Codes,¹¹³ when viewed in light of the exegetical school of thought, the strong adherence to separation of powers,¹¹⁴ and the restrictions on the judiciary, helped to create a legal paradigm in which the judiciary purportedly did not make law but only discovered and applied the relevant enacted law.¹¹⁵ Accordingly, the highest appellate court in private law matters, the *Cour de Cassation*,

110 *Id.* at 375-76.

111 “Il est défendu aux juges de prononcer par voie de disposition générale et réglementaire sur les causes qui leur sont soumises.” C. CIV. art. 5 (Daloz 101st ed. 2002); Crabb, *supra* note 101, at 2 (translating article 5 to read: “Judges are forbidden to pronounce decisions by way of general and regulative disposition on causes which are submitted to them.”); *see* Steiner, *supra* note 100, at 78 (explaining scope of article 5); *see also* Dawson, *supra* note 99, at 375-76, 379 (prohibition against judicial issuance of “regulations” originated in Constituent Assembly of 1790 and was carried over to the *Code Civil* of 1804).

112 *See* Dawson, *supra* note 99, at 412-13.

113 *See* Steiner, *supra* note 100, at 29, 32-33 (discussing the form and appearance of the *Code Civil*, and its claim to comprehensiveness).

114 *See id.* at 76-78 (Law of 16-24 August 1790, precluding the judiciary from exercising legislative power or interfering with legislative process, “forms the basis for the French doctrine of separation of powers”); Dawson, *supra* note 97, at 391-92.

115 *See generally* Dawson, *supra* note 97, at 390-93 (exegetical school promoted view that

nearly always limits its ruling to a terse syllogism that applies one or more provisions of the applicable code to material facts, leading to a conclusion either that the decision of the lower court correctly applied the code and should be affirmed or that the decision should be quashed on the ground that the lower court misapplied the applicable code provisions.¹¹⁶ Even in the rare instances in which the *Cour de Cassation* announces a general principle that applies to a broader category of cases than the single dispute before it, it will do so only if the principle does apply to the case before it, as mandated by article 5.¹¹⁷

The narrow holdings of most French decisions, coupled with the occasional statement of broader principles, could form a body of case law if, in future cases, they were accorded deference to an extent similar to that mandated by the doctrine of *stare decisis* in the United States.¹¹⁸ French judicial decisions, however, are not officially recognized as sources of law and do not create binding precedent on questions of interpretation of code provisions.¹¹⁹ Under such a regime, each case presents a new opportunity to discover the true meaning of a code provision,

legislature was the sole law-making body, to the exclusion of the judiciary, supported by views of Proudhon, an academic who espoused consulting the text of the code for the law, without diverting attention to citations of prior judicial interpretations).

116 *Id.* at 377, 380-81; Mitchell Lasser, *Judicial (Self-)Portraits: Judicial Discourse in the French Legal System*, 104 *Yale L.J.* 1325, 1342 (1995).

117 *Steiner*, *supra* note 98, at 78, 89-90.

118 *See, e.g.*, Charles R. Calleros, *LEGAL METHOD AND WRITING* 22, 51-65 (4th ed. 2004) (discussing case law and *stare decisis* in the United States)..

119 *Steiner*, *supra* note 100, at 75, 79-82.

without formal deference to previous and possibly mistaken judicial interpretations.

Nonetheless, many provisions of the French *Code Civil*, and in particular those of the original 1804 enactment, state general principles rather than detailed rules,¹²⁰ creating gaps in the text in the context of specific disputes.¹²¹ An adherent to the exegetical school might argue that courts, without making law themselves, could fill such gaps by determining what meaning the legislature must have intended in light of the surrounding text and in the general context of the purpose, spirit, and structure of the entire code.¹²² By the close of the Nineteenth Century, however, it became clear that the original code could not keep up with transformations in French society,¹²³ and the exegetical school had come under attack for promoting a fiction of discovering legislative intent in a process dominated by the subjective views and values of the judicial interpreters.¹²⁴ The question whether French judges in fact make law when filling textual gaps has “tortured French lawyers ever since.”¹²⁵

120 *Id.* at 15.

121 Dawson, *supra* note 99, at 391-92 (“great gaps and fissures” had appeared in the *Code Civil* by 1830).

122 *See generally supra* at nn.106-07 and accompanying text.

123 *See* Steiner, *supra* note 100, at 61.

124 *See* Dawson, *supra* note 99, at 394 (referring to an 1899 critique of the exegetical school). Courts may receive guidance in interpreting ambiguous legislation, however, from Parliament in subsequent explanatory statutes, from a government department in a written interpretation submitted in response to a question posed by members of Parliament, or from commentaries published by legal academics). *Id.* at 71-73, 179-85.

125 *Id.* at 399; *see also id.* at 416-31 (reviewing theories that attempt to reconcile the formal

One can reasonably assert that French courts have created at least a weak and informal species of case law that supplements the codes, because attorneys and court officials regularly argue or analyze previous decisions for their persuasive value, though courts generally do not formally acknowledge the precedent in their published judicial decisions.¹²⁶ For example, repeated judicial decisions that reach the same result on an issue in a variety of factual contexts can provide a plausible basis for predicting how a court might react to a similar dispute in the future.¹²⁷ It remains true, however, that previous decisions of even the highest French courts are not *binding* on them or even on lower courts; at most, therefore, they have the status as secondary sources of law.¹²⁸

With this as background, this article next turns to the provisions of the French *Code Civil* that address, or that indirectly shed light on, the enforceability of penalty clauses.

B. Punitive Damages and Penalty Clauses Under the French Civil Code

1. Damages Awarded by the Court in the Absence of a Liquidated

Damages or Penalty Clause

prohibition of judicial lawmaking with the practical reality); Steiner, *supra* note 100, at 75 (French legal academics “argue endlessly and inconclusively over the contradiction between the traditional post-revolutionary concept that law can only be legislative in origin and the reality of judicial lawmaking”); Mattei, *supra* note 89, at 84 (“[i]n practice, courts in civil law countries make law,” citing French judicial development of the law of nuisance as an example).

¹²⁶ See Lasser, *supra* note 116, at 1349-51; Steiner, *supra* note 100, at 82, 97.

¹²⁷ Steiner, *supra* note 100, at 87-88 (discussing concept of *jurisprudence constante*); Dawson, *supra* note 99, at 409 (same, using metaphor of a kaleidoscope formed by multiple decisions).

¹²⁸ See *supra* note 119 and accompanying text.

Specific enforcement of contract obligations compels performance and thus deters further breach in that particular case more directly than a threat of punitive damages. Contrary to the belief of many, however, specific performance of contracts is not sought and granted with substantially greater frequency in France than in the United States.¹²⁹ Thus, damages are the primary remedy in France for breach of contract and are a potential tool for deterrence and retribution.

The French Civil Code, however, explicitly provides for compensatory damages for torts¹³⁰ and breaches of contract,¹³¹ without explicitly mentioning the possibility of punitive

129 See Henrik Lando and Caspar Rose, *On the enforcement of specific performance in Civil Law countries*, 24 Int'l Rev. L. & Econ. 473 (2004). Lando and Rose point out the tension between the apparent right to claim specific performance in France and French Civil Code art. 1142, which limits the state's authority to compel citizens to take certain actions; they report a consensus in the literature that damages for breach of contract is "by far the dominant form of relief" in Germany and France. *Id.* at 478. See also Barry Nicholas, *THE FRENCH LAW OF CONTRACT* 211 (2d ed. 1992) (specific enforcement is a primary remedy in principle in France, but is less important in practice); James Beardsley, *Compelling Contract Performance in France*, 1 Hastings Int'l & Comp. L. Rev. 93, 93-96 (1977) (specific performance in France often is constrained either by article 1142 or by broader considerations similar to those that counsel restraint in common law countries). Even in a case in which the parties could anticipate the availability of specific enforcement as a remedy, in practice this remedy would not necessarily prevent efficient breach and reallocation of resources, because the breaching party might succeed in persuading the victim to release it from obligations in exchange for a share of the profits in the new venture. *Cf. supra* note 87 and accompanying text (making same point about avoiding award of punitive damages if it were available).

130 "*Tout fait quelconque de l'homme, qui cause à autrui un dommage, oblige celui par la faute duquel il est arrivé, à le réparer.*" C. CIV. art. 1382 (Dalloz 101st ed. 2002). Professor Crabb translates article 1382 to read: "Any act whatever of man which causes damage to another obliges him by whose fault it occurred to make reparation." Crabb, *supra* note 101, at 252.

131 "*Les dommages et intérêts dus au créancier sont, en général, de la perte qu'il a faite et du*

damages for either. As with many other civil law countries, punishment is generally reserved for the criminal law.¹³²

The exclusion from civil liability of damages that are punitive in nature is not absolute. Some statutes, for example, authorize a court to impose a civil fine, known as *amende civile*, for certain kinds of serious wrongs that warrant a punitive response but not necessarily criminal sanctions.¹³³ A judge might also respond to a particularly egregious tort or breach of contract with a generous damages award that is compensatory in name but that arguably includes a covert punitive element. For example, the French Civil Code permits a court to award the full damages caused by a bad-faith breach of contract, free of the foreseeability limitation that would otherwise apply.¹³⁴ This lifting of the foreseeability requirement must cause some awards for bad faith

gain dont il a été privé, sauf les exceptions et modifications ci-après.” C. CIV. art. 1149 (Dalloz 101st ed. 2002). Professor Crabb translates article 1149 to read: “Damages due to a creditor are, in general, from the loss which he incurred and from the gain of which he was deprived, apart from the hereinafter exceptions and modifications.” Crabb, *supra* note 101, at 223. Article 1147 states that the debtor is liable to the creditor for nonperformance or late performance, subject to some excuses for nonperformance. *Id.* at 222 (translating French text of article 1147).

132 See Gotanda, *supra* note 3, at 193.

133 See, e.g., C. COM. art. L 442-6 (French Commerce Code modified in 2001 to authorize a fine of two million euros for distortion of competitive markets); Martine Béhar-Touchais, *L’Amende Civile Est-elle un Substitut Satisfaisant À L’Absence de Dommages et Intérêts Punitifs?*, *Petite Affiche* N° 232, Nov. 20, 2002, at 36-44 (discussing whether the *amende civile* is adequate to compensate for the absence of punitive damages under French law).

134 “*Le débiteur n’est tenu que des dommages et intérêts qui ont été prévus ou qu’on a pu prévoir lors du contrat, lorsque ce n’est point par son dol que l’obligation n’est point exécutée.*” C. CIV. art. 1150 (Dalloz 101st ed. 2002). Professor Crabb translates article 1150 to read: “A debtor is held only to damages which were foreseen or which could have been foreseen at the time of the contract, when it is not by his willfulness that the obligation is not executed.” Crabb,

breach to blur the line between maximum compensation and punishment.¹³⁵

Finally, *astreint* is a legislatively authorized judicial mechanism for compelling a breaching party to perform its obligations after a judicial finding of breach of obligation in a broad range of civil fields.¹³⁶ An *astreinte* is an order compelling the breaching party to pay the victim of breach a certain sum of money for each day, week, or other designated period that performance of the obligation is further delayed; because the judge can impose the *astreinte* in addition to full compensatory damages,¹³⁷ its purpose is to deter further breach.

The *astreinte* might be likened to a front-loaded contempt sanction for violation of a court order, or perhaps as a penalty clause of judicial origin. This second analogy, in turn, raises the topic of our next inquiry.

2. Enforcement of the *Clause Pénale* under the French Civil Code

a. Textual Analysis of the Code as Enacted in 1804

In light of the absence of a formal doctrine of stare decisis in French law, and in the spirit of the traditional view of the French Civil Code as comprehensive and internally consistent, an analysis of the code's application to a particular issue ought to begin with the text of all articles

supra note 101, at 233.

135 See generally 5 Arthur Corbin, CORBIN ON CONTRACTS § 1077, at 437-48 (1964) (commenting on difficulty of relying on “nice distinctions between compensation and punishment” in contract remedies).

136 Law No. 72-626 of July 5, 1972, J.O. July 9, 1972, p. 7181; Law No. 91-650 of July 9, 1991, J.O. July 14, 1991, p. 93??; Beardsley, *supra* note 129, at 101.

137 See Law of July 5, 1972, *supra* note 136, art. 6; Law of July 9, 1991, *supra* not 136, art. 34.

of the code that may shed light on the topic.

The plain text of the French Civil Code supports an argument, albeit a strained one, that extra-compensatory stipulated damages are not recognized under the code. Article 1226 of the French Civil Code defines “*clause pénale*” as a clause that is designed “*pour assurer*” performance of a contract by committing a breaching party to some alternative obligation or contractual liability.¹³⁸ Modern French dictionaries define “*assurance*” as an indemnity insurance policy,¹³⁹ and “*assurer*” as “to insure.”¹⁴⁰ Thus, when article 1226 states that a *clause pénale* is designed “to insure” (“*pour assurer*”)¹⁴¹ performance, it could refer to a liquidated damages clause designed to provide indemnification in the sense of compensation for actual injury. Even section 1226's use of the term “*clause pénale*,” which literally means “penalty clause,”¹⁴² might be assigned a counter-intuitive definition by article 1229 of the Code. The first line of article 1229 appears – at least when viewed in isolation – to limit a *clause pénale* to

138 “*La clause pénale est celle par laquelle une personne, pour assurer l'exécution d'une convention, s'engage à quelque chose en cas d'inexécution.*” C. CIV. art. 1226 (Dalloz 101st ed. 2002). Professor John H. Crabb has translated article 1226 to read: “A penalty clause is one whereby a person, in order to insure execution of an agreement, binds himself to something in case of inexecution.” Crab, *supra* note 101, at 236.

139 Henry S. Dahl, DAHL'S LAW DICTIONARY, French to English/English to French 26 (2001).

140 Michael Doucet, LEGAL AND ECONOMIC DICTIONARY 22-23 (1980).

141 See *supra* note 138 (setting forth language of the *Code Civil* as well as Professor Crabb's translation into English).

142 *Id.* When used outside the contractual context, “*pénal*” or “*pénale*,” is an adjective that typically refers to things related to the criminal justice system, reinforcing its association with penalties. Dahl, *supra* note 139, at 244.

nonpunitive liquidated damages, because it states that a “penalty clause is the compensation for damages” (“*La clause pénale est la compensation des dommages*”)¹⁴³ suffered by the victim of breach.

Finally, the first sentence of article 1152 (which sets for the complete text of that article as originally drafted) refers to enforcement of contractual provisions requiring payment of “a sum certain in damages” (“*une certaine somme à titre de dommages-intérêts*”)¹⁴⁴ for breach, and does not refer to the term “*clause pénale*.”¹⁴⁵ It thus could be read to provide only for enforcement of nonpunitive liquidated damages clauses, even if the term “*clause pénale*” refers to a true penalty clause in articles 1226 and 1229.¹⁴⁶

An alternative explanation, however, gives the term “*clause pénale*” its more natural

143 “*La clause pénale est la compensation des dommages et intérêts que le créancier souffre de l’inexécution de l’obligation principale.*” C. CIV. art. 1229 (Daloz 101st ed. 2002). As translated by Professor Crabb, the first line of article 1229 reads: “A penalty clause is compensation for damages which the creditor suffers from the inexecution of the principal obligation.” Crabb, *supra* note 101, at 232. Dahl defines “*clause pénale*” as a penalty clause or as “liquidated damages,” the latter being a common term for stipulated damages that are compensatory in nature. Dahl, *supra* note 138, at 57-58. Dahl does not indicate, however, whether that association with the broader term, liquidated damages, is a relatively recent phenomenon or might have been current in 1804.

144 The first sentence of article 1152 reads: “*Lorsque la convention porte que celui qui manquera de l’exécuter payera une certaine somme à titre de dommages-intérêts, il ne peut être alloué à l’autre partie une somme plus forte, ni moindre.*” C. CIV. art. 1152 (Daloz 101st ed. 2002). As translated by Professor Crabb, this sentence reads: “When an agreement provides that he who fails to execute it shall pay a sum certain by way of damages, there may not be awarded to the other party a greater or lesser sum.” Crabb, *supra* note 101, at 233.

145 *Id.*

146 See Denis Mazeaud, *La Notion de Clause Pénale* § 510, at 295 (1992).

meaning as one that provides for extracompensatory damages, and it permits the broader language of article 1152 to refer to enforcement of any stipulated damages clause, whether a nonpunitive liquidated damages clause or a true penalty clause. The term “*assurer*” in article 1226, although sometimes translated to mean “to insure,” and sometimes associated with the provision of indemnity insurance,¹⁴⁷ could easily have been used to mean “to ensure” in the sense of ensuring performance, or “to assure,” in the sense of providing reassurance by signaling an absolute commitment to perform.¹⁴⁸ Indeed, “*assurer*” is unambiguously used in that last sense in other, more recently amended civil code provisions.¹⁴⁹ These possible connotations of “*assurer*” would point to a clause that seeks to deter breach by requiring payment of extracompensatory damages, and such an interpretation would fit more naturally with the literal meaning of “*clause pénale*,” (literally, “penalty clause”)¹⁵⁰ used in the same article. This interpretation is also consistent with the diction and syntax of article 1226, which links the verb “*assurer*” to performance (*pour assurer l’exécution*)¹⁵¹ rather than to nonperformance, suggesting

147 See *supra* notes 138-40.

148 Cf. *supra* notes 89, 90 and accompanying text (discussing a penalty clause’s possible purpose of signaling a promisor’s reliability).

149 E.g., C. CIV. art. 80 (amend. 1993, Dalloz 101st ed. 2002) (“*Celui-ci s’y transportera pour s’assurer du décès et en dressera l’acte . . .*”). As translated by Crabb, this passage reads: “The latter will repair there to assure himself of the death and draw up a certificate of it, . . .” Crabb, *supra* note 101, at 13.

150 See *supra* notes 138, 143 (setting forth language of the *Code Civil* as well as Professor Crabb’s translation into English).

151 *Supra* note 138.

that the article refers to ensuring performance rather than indemnifying for breach.

Although the first line of article 1229, when viewed in isolation, may appear to equate the term “*clause pénale*” rather unnaturally with compensation rather than punishment (“*La clause pénale est la compensation de dommages . . .*”),¹⁵² the second line suggests a different perspective. The second line of article 1229 prohibits the victim of breach from simultaneously demanding both the stipulated damages and performance of the principal obligation, except when the stipulated damages are solely for breach due to delay.¹⁵³ In that light, the first line of article 1229 may not be intended to state that the clause necessarily is limited to a compensatory measure of damages; rather, it probably is intended to emphasize that the *clause pénale* generally provides the sole redress, in the sense of the exclusive remedy, for breach.

Finally, because article 1152 does not restrict its terms to stipulated damages clauses of a particular measure, its provision for enforcement of contractual agreements for payment of “damages”¹⁵⁴ could refer quite naturally to payment of damages of either compensatory or extracompensatory measure. That the French Civil Code could contemplate enforcement of a

152 *Supra* note 143 (setting forth language of the *Code Civil* as well as Professor Crabb’s translation into English).

153 “*Il ne peut demander en même temps le principal et la peine, à moins qu’elle n’ait été stipulée pour le simple retard.*” *Id.* As translated by Professor Crabb, the second line of article 1229 reads: “He may not claim at the same time the principal obligation and the penalty, unless it was stipulated for a mere delay. Crabb, *supra* note 100, at 232.

154 *See supra* note 144 (setting forth Professor Crabb’s translation of the term “*dommages-intérêts*” in article 1152).

penalty is suggested by the Code's recognition of freedom to contract in article 1134,¹⁵⁵ one manifestation of the post-revolutionary regard for individual liberty and autonomy.¹⁵⁶

To help resolve a debate about which of the above textual analyses is most consistent with legislative intent, even the exegetical school of the Nineteenth Century would look beyond the text and gather evidence of legislative purpose from legislative history, or *travaux préparatoires*.¹⁵⁷ The legislative history of the 1804 French Civil Code supports the second textual analysis above, which in turn mandates enforcement of contractual penalty clauses. A preliminary draft of article 1152 authorized judges to reduce stipulated damages that obviously exceeded actual damages, but objections to that draft, based on respect for the parties' agreement, prevailed.¹⁵⁸ The final language of article 1152, as enacted in 1804, provided that judges were

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Article 1134 provides that the law generally will defer to the will and the agreement of the parties when executed in good faith:

Les conventions légalement formées tiennent lieu de loi à ceux qui les ont faites.

Elles ne peuvent être révoquées que de leur consentement mutuel, ou pour les causes que la loi autorise.

Elles doivent être exécutées de bonne foi.

C. CIV. art. 1134 (Dalloz 101st ed. 2002). As translated by Professor Crabb, article 1134 reads:

Agreements legally made take the place of law for those who make them.

They may be revoked only by mutual consent or for causes which the law authorizes.

They must be executed in good faith.

Crabb, *supra* note 101, at 221.

156 See Mazeaud, *supra* note 146, § 53, at 43 (referring to the principle of *autonomie de la volonté* (autonomy of the will), a fundamental concept of French contract law).

157 See Steiner, *supra* note 100, at 61, 67-70.

158 Mazeaud, *supra* note 146, §§ 512-14, at 295-96.

bound to enforce the precise amount of stipulated damages agreed to by the parties.¹⁵⁹

Accordingly, the *Cour de Cassation* interpreted the 1804 French Civil Code to mandate judicial enforcement of *clauses pénale* as written, without judicial adjustment of any penalties.¹⁶⁰

It might seem anomalous, particularly to one with common law sensibilities, for French law to largely exclude judicial awards of punitive damages from a broad category of civil liability, including liability for torts as well as breaches of contract, but then to enforce contractual penalties originating with the contracting parties. The common law approach appears to earn higher grades for consistency, at least within the field of contract law: even though it permits punitive damages for egregious torts,¹⁶¹ it generally denies punitive damages for breach of contract, whether awarded independently by the court¹⁶² or originating with the parties in unreasonably large liquidated damages.¹⁶³

The approach of the 1804 French Civil Code, however, can be explained by the post-revolutionary backlash against the judiciary¹⁶⁴ and newly won respect for individual liberty and

159 *Supra* note 144.

160 *See, e.g.*, Cass. 1e civ., Nov. 21, 1967, No. 337; Cass. 1e civ., June 1, 1937.

161 *Supra* notes 1-6 and accompanying text.

162 *Supra* notes 7-15 and accompanying text.

163 *Supra* notes 16-21 and accompanying text.

164 *See supra* notes 108-111 and accompanying text.

autonomy.¹⁶⁵ The power of the judiciary would be held in check if the Napoleonic Codes generally required criminal process for judicial imposition of penalties,¹⁶⁶ while simultaneously requiring courts to respect the rights of individuals to freely enter into a contract in which they agreed to impose a penalty for breach.¹⁶⁷

b. Amendments to Article 1152

Beginning in the 1970's, the French devotion to freedom of contract was tempered by recognition that parties with greater sophistication and bargaining power could employ *clauses pénale* to threaten the other party with excessive penalties or forfeitures for breach or to limit their own liability to an unconscionable degree.¹⁶⁸ As a result, article 1152 was amended in 1975 to authorize the exercise of judicial discretion to reduce or increase the stipulated sum in a *clause pénale* if the judge first determines that the clause is manifestly excessive or plainly inadequate.¹⁶⁹ A companion amendment directs judges to apportion damages under a *clause*

¹⁶⁵ *Supra* notes 155-56.

¹⁶⁶ *See supra* note 132 and accompanying text.

¹⁶⁷ Mazeaud, *supra* note 145, §§ 512-13, at 295-96.

¹⁶⁸ *See* Mazeaud, *supra* note 146, §§ 40-52, at 35-42.

¹⁶⁹ Article 1152 was amended again in 1985 to authorize a judge to take these actions on the judge's own motion. The discretion to modify the damages seems squarely at odds with the original language of article 1152, *supra* note 144, which remains in place and which directs a judge to enforce a damages clause in precisely the agreed amount, creating an awkward juxtaposition between the original text and the subsequent additions. As amended in 1975 and 1985, article 1152 now includes the following clauses, inserted as a new paragraph immediately after the language in the original 1804 provision:

pénale in the event that the victim of the breach has received the benefit of partial performance, while still leaving the judge free to adjust the stipulated damages further, if appropriate, pursuant to article 1152.¹⁷⁰ Both articles were amended in 1985 to permit the judge to adjust the stipulated damages on the judge's own motion,¹⁷¹ a significant development in light of new rules of civil procedure that generally limit judicial action to claims and issues raised by the parties.¹⁷² These articles are supplemented by other laws that permit judges in narrow circumstances to strike

Néanmoins, le juge peut, même d'office, modérer ou augmenter la peine qui avait été convenue si elle est manifestement excessive ou dérisoire. Toute stipulation contraire sera réputée non écrite.”

C. CIV. art. 1152 (Daloz 101st ed. 2002). Professor Crabb translates this passage to read:

Nevertheless, the judge, even on his own motion, may moderate or increase the penalty which had been agreed upon, if it is manifestly excessive or pitiful. Any contrary stipulation will be considered not written.

Crabb, *supra* note 100, at 223. Of course, if it were ever in doubt whether article 1152 authorized enforcement of contractual penalties, *see supra* section II.B.2.a, the language of the amended article puts that doubt to rest by specifically referring to penalties and to judicial authorization to moderate them.

170 C. CIV. art. 1231 (Daloz 101st ed. 2002).

171 *Id.*; C. CIV. art. 1152 (Daloz 101st ed. 2002) (amendment set forth and translated *supra*, note 169).

172 *See* THE FRENCH CODE OF CIVIL PROCEDURE IN ENGLISH 1 (Christian Dodd, trans. 2004) (Article 4 provides that the “subject matter of a dispute shall be determined according to the respective claims of the parties.”); *id.* at 2 (Article 5 provides that a “judge must rule upon all the points at issue and only upon them.”); Mazeaud, *supra* note 146, §§ 61, 67 & 69, at 46, 49 (referring to judicial discretion in article 1152, raising of issue on judge's own motion, and tension with new rules of civil procedure); Steiner, *supra* note 100, at 168 (referring to restrictions in New Code of Civil Procedure on judicial initiatives).

down, rather than simply modify, stipulated damages or limitations on liability.¹⁷³

The French courts have not been entirely consistent in the time frame that they employ to resolve the threshold question of manifest excess in clauses that impose extracompensatory damages.¹⁷⁴ In most cases, however, courts have applied an objective, retrospective test that compares the stipulated damages to the damages actually sustained.¹⁷⁵ As discussed in section II.A. above, even published decisions of the *Cour de Cassation* do not constitute primary legal authority that binds itself or other courts; however, general predictions may be based on the high court's rulings that the breaching party's bad faith in the performance and breach of the contract is not relevant to the initial question of manifest excess in the penalty clause, or at least cannot be

173 See, e.g., *supra* note 155 (deference to parties' agreement in article 1134 is subject to execution of the agreement in good faith); C. CIV. art. 1108, 1131, 1133 (a contract that violates public policy or morals lacks legitimate "cause," a requisite for formation of an enforceable contract); Law of Jan. 10, 1978, art. 35 (highest court for administrative law, the Conseil d'Etat, is authorized to limit, regulate, or even prohibit abusive clauses ("*clauses abusives*") in contracts between professionals and consumers).

174 See Mazeaud, *supra* note 146, § 86, at 57-58 (explaining that courts in a minority of cases have determined the excessive character of a *clause pénale* based on a number of factors surrounding formation of the contract, while courts in the majority of cases have used an objective, retrospective test).

175 See *id.*; Cass. com., Jan. 22, 2002, No. 99-12683 (unpublished) (approving appellate court's finding that penalty clause was not grossly excessive when compared to actual damages). *But cf.* Cass. 3e civ., Jan. 12, 1994, No. 91-19540, Bull. civ. 3, No. 5 (enforcing *clause pénale* even though the victim of breach suffered no actual injury, suggesting either a determination that the *clause pénale* was not manifestly excessive when imposed in the absence of zero actual damages or that the court was justified the award on the basis of a comparison of the penalty with the damages that could reasonably have been estimated by the parties at the time of contracting).

the sole determining factor.¹⁷⁶ It would not be surprising if the courts settle into a pattern of determining manifest excess solely or largely on the basis of the court's comparison of the stipulated damages to actual injury or to the total value of the contract, while allowing nearly unlimited equitable discretion in determining the extent to which the punitive surplus should be reduced, if at all, once a penalty clause is found to be manifestly excessive.¹⁷⁷ Such an approach would be consistent with the text of article 1152, which refers abstractly to a penalty clause's status as manifestly excessive while more specifically and personally granting the judge authority, without stating any limitation, to moderate a manifestly excessive clause.¹⁷⁸

The amended version of article 1152 potentially gives French judges the power to bring their law regarding *clauses pénale* in line with the common law antipathy to penalty clauses. If judges consistently find extracompensatory stipulated damages to be manifestly excessive, and if they reduce the stipulated damages to an amount that approximates either the actual injury or a reasonable prospective estimate of the injury that breach would cause, the approaches of the two legal systems will be substantially identical.

The final sentence in amended article 1152, however, speaks not of moderating the total

176 See, e.g., Cass. com., Feb. 5, 2002, No. 99-13463 (unpublished) (lack of bad faith and substantial fault in connection with breach not properly considered by court of appeals in determination of whether penalty clause is manifestly excessive); cf. Cass. com., Feb. 11, 1997, No. 95-10851, Bull. civ. IV, No. 47 (behaviors of the parties cannot be sole basis for a finding of manifestly excessive penalty; comparison of the penalty to actual damages suffered is a necessary element of the analysis).

177 See, e.g., Cass. Com., Feb. 11, 1997, *supra* note 176.

damages referred to in the first sentence, but of moderating the *penalty*, suggesting that the penalty portion of the total sum of damages will not be *eliminated*, leaving only compensation, but may be *moderated*, leaving compensation plus a smaller penalty. In practice, the courts have indeed retained the discretion to reduce a manifestly excessive *clause pénale* to a higher point that still exacts a penalty, albeit a reduced one.¹⁷⁹ Indeed, all members of two small groups of French magistrates that I interviewed in 2005 stated that they would normally retain an extracompensatory element in a *clause pénale*, even after moderating it to avoid a manifestly excessive penalty, in keeping with the parties' intent to discourage breach. Authority for retaining such a punitive element arguably lies in article 1226, which defines, without condemning, a *clause pénale* as one designed to ensure performance,¹⁸⁰ and thus to deter further breach of that particular contract by compelling performance.¹⁸¹

Additionally, if the breaching party acted in bad faith, judicial retention of a punitive element in a *clause pénale* might be encouraged by article 1133's expansive view of

178 *See supra* note 169.

179 *See* Cass. Com., Jan. 29, 1991, No. 89-16446, Bull. civ. IV. No. 43 (approving award with punitive element beyond compensation).

180 *Supra* notes 138 & 147-51 and accompanying text.

181 *See* Cass. Com., Jan. 29, 1991, *supra* note 179 (after citing article 1226, noting that compensation for loss is not the exclusive function of a *clause pénale*, which can also function to compel performance); *see also* Mazeaud, *supra* note 146, at 7 (in light of the purpose of compelling performance, arguing that even a revised *clause pénale* should always remain slightly higher than actual damages, and that the judge should award some amount under a *clause pénale* even if the nonbreaching party suffers no injury).

compensatory damages for bad faith breach.¹⁸² Because judges are accustomed to awarding an expanded measure of compensatory damages for bad faith breach when acting without the benefit of a *clause pénale*, they likely will feel comfortable exercising discretion to lessen their reductions of manifestly excessive *clauses pénale*, leaving some extra-compensatory damages for bad faith breach, when the parties have voluntarily agreed to a penalty. Even though the *Cour de Cassation* has quashed lower court decisions that considered the bad faith, or lack of bad faith, of a party on the threshold issue of manifest excess in the *clause pénale*,¹⁸³ a judge almost certainly has broader discretion to consider the breaching party's bad faith when exercising discretion to reduce stipulated damages that the judge has independently found to be manifestly excessive.

Finally, in comparison to common law judges, French judges are generally more willing to view a contractual promise as a moral obligation and are less persuaded by arguments of economic efficiency.¹⁸⁴ When coupled with the strong regard for freedom of contract and the pre-1975 tradition of enforcing penalty clauses as written, these values presumably will frequently translate into enforcement of penalties: in some cases judges will find penalties to be fully enforceable rather than manifestly excessive; in other cases, they will moderate a manifestly excessive penalty but not to the point of eliminating all extra-compensatory damages.

c. Summary

182 See *supra* notes 134-35 and accompanying text.

183 See *supra* note 176 and accompanying text.

184 Nicholas, *supra* note 129, at 211-13. This sentiment was echoed by French magistrates that I

In sum, in contrast to both the common law and the Uniform Commercial Code in the United States,¹⁸⁵ the French Civil Code permits judges to enforce contractual penalties for breach of contract. The practice of enforcing penalty clauses was strongly established under the original language of article 1152, which mandated enforcement of stipulated damages without adjustment of the amount, respecting freedom of contract.¹⁸⁶ Although the amendments to article 1152 in 1975 and 1985 authorize the judiciary to moderate manifestly excessive penalty clauses, the judges retain the discretion to permit a punitive element to remain. When judges exercise their discretion in that manner, either they have made a determination that the breach is not efficient or – and this is more likely in the context of French legal culture – they are acting on the assumption that economic efficiency is less important than respecting the parties’ freedom to agree to a monetary means of compelling performance, which can substitute for the coercive remedy of specific enforcement. This view is supported by the code’s reference to the purpose of a *clause pénale* to ensure performance.¹⁸⁷

The wild card in this remedial scheme is the *astreinte* the equivalent of a graduated penalty clause drafted by the court rather than the parties and imposed for the same purpose of

interviewed in 2005.

185 *See supra* note 17.

186 *See supra* notes 154-60 and accompanying text.

187 *See supra* note 138 & 147-51 and accompanying text.

compelling performance.¹⁸⁸ This judicial power does not sit comfortably within a legal system in which punitive damages generally are excluded from civil liability except when interests in protecting autonomy and freedom of contract require enforcement of a contractual *clause pénale*. This apparent anomaly is minimized at least, if commentators are correct in noting that this remedy, like specific performance, is enforced “in a very grudging manner.”¹⁸⁹

III. Lessons from the Comparative Analysis

A. Summary of the French and American Approaches

U.S. law and French law are consistent in their refusal, with some exceptions, to grant punitive damages for breach of contract in the absence of a contractual penalty clause.¹⁹⁰ If the parties have freely negotiated a stipulated damages clause, however, the approaches of the two legal systems diverge, although the divergence is less pronounced than might be apparent on the surface.

In the United States, stipulated damages clauses are enforceable only if they represent reasonable attempts to liquidate compensatory damages; unreasonably large stipulated damages are unenforceable as a penalty, reflecting an antipathy that traces back 500 years to the English

188 See *supra* note 135-36 and accompanying text.

189 Konrad Zweigert and Hein Kötz, INTRODUCTION TO COMPARATIVE LAW 475 (1998) (referring to of grants specific performance and *astreinte*; see also Lando and Rose, *supra* note 129, at 478 (quoting Zweigert and Kötz and agreeing that this “special system of fines” is not strictly enforced by the courts).

190 See *supra* notes 7-15, 130-37, 189, and accompanying text.

equity practice of granting relief from extra-compensatory conditional bonds.¹⁹¹ U.S. law, however, defers to the parties' freedom to contract in one minor way: it will enforce a liquidated damages clause that is prospectively reasonable at the time of contracting, even if the liquidated damages exceed actual damages because the breach causes unexpectedly little injury.¹⁹²

Throughout much of the history of the Napoleonic Code, French law deferred to the contracting will of the parties to a far greater degree by enforcing validly negotiated *clauses pénale*, without adjustment, even if the clauses imposed penalties both from a prospective and retrospective view.¹⁹³ After 1975, French law retreated from its position of total deference to the will of freely contracting parties, granting authority to judges to eliminate or moderate the punitive element of a *clause pénale* if it was found to be manifestly excessive, which the courts usually assessed by retrospectively comparing the clause with actual damages caused by breach.¹⁹⁴

From a U.S. perspective, French law offers a more favorable environment for enforcing penalty clauses, even after 1975, because it will enforce any extra-compensatory clause that is not retrospectively manifestly excessive, and it offers the probability of enforcing part of a penalty

191 *See supra* notes 29-36 and accompanying text.

192 *See supra* notes 17-21 and accompanying text.

193 *See supra* notes 147-67 and accompanying text.

194 *See supra* notes 168-183 and accompanying text.

clause that is manifestly excessive and must be reduced.¹⁹⁵ From a French perspective, however, U.S. law – although exhibiting greater hostility toward penalty clauses in its rhetoric – appears to give penalties a partial reprieve, because it enforces liquidated damages that are prospectively reasonable but that turn out to be extra-compensatory after actual injury is sustained.¹⁹⁶

B. A Proposal to Consider Facets of the French Approach, While Retaining Goals of Efficiency and Guarding Against Abusive Penalty Clauses

One steeped in American law, and particularly in the school of law and economics, might advise the French Parliament to complete the evolution of the Civil Code begun in 1975 by eliminating the enforcement of all extra-compensatory *clauses p nale*, to facilitate efficient breaches and encourage economic growth. This author believes, however, that U.S. law may have more to gain by adopting features of the French approach. By distinguishing contractual penalty clauses from court-awarded punitive damages, and by adopting sufficient flexibility to distinguish efficient breaches from inefficient and malicious breaches, U.S. law could achieve results that are fairer to the victim of breach.

First, as shown in the approach of the French Civil Code, penalty clauses, if freely and fairly negotiated, need not be treated with the same hostility accorded to court-awarded punitive damages for breach of contract. If the parties with relatively equal bargaining position have negotiated a penalty clause for the purpose of providing one party with special reassurance

¹⁹⁵ *See id.*

¹⁹⁶ *See supra* notes 20-21 and accompanying text.

against breach, the other party likely is agreeable to using the clause as a means of signaling its serious intention to perform, and its acceptance of the clause puts it in a better position to extract a higher fee for the promised services.¹⁹⁷ A legal regime that signals at least partial enforceability of such agreements will give substance to such clauses and will help the parties to maximize the benefits that they can derive from bargaining.¹⁹⁸

This approach rests strongly on an assumption of mutual consent without overreaching, requiring vigilant policing by courts to guard against fraud, duress, and unconscionability. Indeed, courts might desire to take a modest step in the direction of this approach by enforcing only a penalty clause that is specifically negotiated by these parties, or – in the case of a standard-form clause – is brought to the attention of the non-drafting party¹⁹⁹ and – if the clause would operate solely against one party – is subject to deletion in exchange for a reasonable change in fee, rather than unalterably included as part of an adhesion contract.²⁰⁰ Penalty clauses that do not meet these standards would generally be unenforceable as unconscionable contract terms or as ones that violate public policy.

The purpose of adopting a rule that permitted enforcement of penalty clauses would be to

197 *See supra* notes 88-95 and accompanying text.

198 *See supra* notes 88-91 and accompanying text.

199 *See supra* note 92;*cf., e.g.*, U.C.C. § 2-205 (1998) (requiring separate signing of promise to hold offer open if made on form supplied by other party).

200 *See generally* Crawford v. Buckner, 839 S.W.2d 754, 757-59 (Tenn. 1992) (exculpatory clause in residential lease violated public policy, partly because it adhered to the contract and was not subject to removal in exchange for tenant's payment of additional fees).

compel or ensure performance in transactions in which the victim of breach would find compensatory damages to be an inadequate substitute for actual performance and in which specific performance would be impractical or otherwise not readily obtainable. Recall, for example, the hypothetical wedding reception in which the wedding couple places great sentimental value on the appearance of a particular musical group;²⁰¹ if that group repudiated at the last minute or simply failed to show up, the wedding couple would find it impossible to secure specific performance of that band, and would find it nearly impossible to secure the services of any comparable and available band. It is unlikely that a court would define the couple's expectation interest in a manner that would allow compensatory damages to fully remedy their sense of injury.²⁰² In such a case, the wedding couple might be willing to pay a

201 *See supra* notes 88-95 and accompanying text.

202 *See, e.g.,* Levin v. Halston Ltd., 398 N.Y.S.2d 339, 341 (N.Y. City Ct. 1977) (denying damages for emotional distress for alleged breach of contractual duty to supply well-fitting dress for wedding); *see also* Restatement (Second) of Contracts §§ 351 (limitations on damages related to foreseeability); *id.* at § 352 (damages not recoverable unless proved with reasonable certainty); *id.* at § 353 (damages for emotional distress excluded in the absence of bodily harm unless the breach, by its nature, would quite likely cause "serious emotional disturbance"). The Restatement suggests that damages might be calculated on the basis of the nonbreaching party's subjective valuation of the contract's subject matter, *id.* at § 347(a) ("the loss in value to him"); however, the nonbreaching party may have difficulty establishing the foreseeability of such loss, *see id.* at § 351, and establishing the loss with reasonable certainty, *see id.* at § 348 (default rules that apply "if the loss in value to the injured party is not proved with reasonable certainty"). In one celebrated case, an appellate court declined to award damages of \$29,000 measured by the cost to complete restoration of the nonbreaching parties' farm land after the breaching party had stripped mined it for coal, and it instead awarded the sum of \$300, representing the diminution in market value. Peeveyhouse v. Garland Coal & Mining Co., 382 P.2d 109 (Okla. 1962). Finally, if the general marketplace would be equally satisfied with a substitute swing band that cost no more than the contract fee for the wedding couple's favored band, and if the court did not allow

premium to secure an elevated commitment from the band through its acceptance of an enforceable clause that would deter breach through extra-compensatory damages.

Granting punitive damages for innocent breach in the absence of a freely negotiated penalty clause would punish a party who is both blameless and who did not agree to assume the risk of a penalty. A freely negotiated penalty clause, however, could justifiably apply to unintentional as well as deliberate breaches. If the law predictably enforces a penalty clause against even innocent breach, obligors who negotiated a premium for assuming the risk of paying a penalty for breach will have an incentive to take precautions against inadvertent breach, in addition to obvious incentives to refrain from recklessly or intentionally breaching the contract.

Just as due process imposes limits on punitive damage awards in tort actions,²⁰³ under this proposal the law should impose upper limits on enforceable penalty clauses. Indeed, in light of the historical common law antipathy toward punitive damages and stipulated penalties in contracts actions,²⁰⁴ considerations of public policy and the need to guard against overreaching should impose stricter limits than would be imposed by due process in the absence of an enforceable penalty clause. As with the rule of reasonableness in enforcing noncompetition

the sentimental value associated with the favored band to preclude a finding that another band was a valid substitute, then principles of avoidability could bar all compensatory damages other than the transactions costs of finding and hiring a substitute band. See Restatement (Second) of Contracts § 350 (1981) (barring recovery for loss that reasonably could have been avoided “without undue risk, burden or humiliation”).

203 *See supra* note 5.

204 *See supra* notes 7-38 and accompanying text.

clauses,²⁰⁵ courts should enforce penalty clauses only to the extent that they are necessary to protect the legitimate interests of the parties.²⁰⁶

This proposal contemplates, however, that some parties will have a legitimate interest in deterring breach, perhaps because they reasonably contemplate that compensatory damages, if defined conventionally, will not adequately protect their interests. In such circumstances, a court could exercise its policing powers to enforce “reasonable” penalties, those designed to provide a reasonably effective extracompensatory disincentive to breach, but not one that would provide an additional windfall to the plaintiff or would reflect excessive vindictiveness toward the breaching party. A penalty clause that failed this test would be struck down on grounds of unconscionability²⁰⁷ or public policy,²⁰⁸ or would be modified to eliminate the objectionable surplus.²⁰⁹

The proposed rule would apply effectively to intentional efficient breaches, even while retaining a strong policy of encouraging efficient allocation of resources. In balancing the

205 See, e.g., *Hopper v. All-Pet Animal Clinic*, 861 P.2d 531, 540 (Wyo. 1993); Restatement (Second) of Contracts § 186(1) (1981); Harlan M. Blake, *Employee Agreements Not to Compete*, 73 Harv. L. Rev. 625, 648-49 (1960).

206 See, e.g., *Hopper*, 861 P.2d at 545; Restatement (Second) of Contracts § 188(1)(a) (1981).

207 See, e.g., U.C.C. § 2-302 (1998); Restatement (Second) of Contracts § 208 (1981).

208 See, e.g., Restatement (Second) of Contracts §§ 178-79 (1981).

209 See, e.g., *Central Adjustment Bureau, Inc. v. Ingram*, 678 S.W.2d 28 (Tenn. 1984) (approving judicial modification of an unreasonable but good-faith noncompetition clause so that it comported with public policy, and enforcing it as modified); see generally U.C.C. § 2-302 (1998) (authorizing a court to “limit the application” of an unconscionable contract clause).

parties' freedom to contract, due recognition of their legitimate interests, and a public policy favoring economic efficiency, a court could reduce any excessive penalty so that it facilitated reallocation of resources to a higher use but still guaranteed some portion of the extracompensatory damages for which the victim of breach bargained, particularly considering any premium that the victim paid in exchange for inclusion of the penalty clause. In keeping with the centuries-old practice of Chancery courts to grant equitable relief from oppressive penal bonds,²¹⁰ but emulating the flexibility provided by the French Civil Code, a revised American law could vest courts with discretion to eliminate the portion of a contractual penalty that served no purposes except to produce a windfall and block a more economically efficient result.

For example, suppose that the victim of breach expected to, and actually does, suffer net damages of \$10,000, measured by conventional standards and after factoring in costs avoided by withholding the breaching party's fee of \$101,000. Because of great sentimental investment in the promised performance, investment that likely would not be fully protected by an award of compensatory damages under conventional market-based measures, the nonbreaching party had successfully negotiated a penalty clause that called for \$20,000 in damages in the event of breach (over and above the withholding of the breaching party's fee), paying a premium of \$1,000 for inclusion of the clause. Before performance was due, the other party intentionally breached to take advantage of an intervening opportunity that will pay it \$150,000 and will net for the breaching party a profit of \$30,000, which amounts to \$20,000 more than the \$10,000 it would

²¹⁰ See, *supra*, note 35 and accompanying text.

have earned under the first contract. If the penalty clause were unenforceable, the victim of the breach would be entitled only to a conventional measure of her compensatory damages (\$10,000), secured perhaps only after expenditure of significant transactions costs. Fully enforcing the penalty clause, however, would eliminate the breaching party's economic incentive to reallocate its resources to a use that the market values more highly. Taking a cue from the French authority to moderate a *clause pénale* in certain circumstances,²¹¹ a court could vindicate public policy and could recognize both freedom of contract and the legitimate interests of the parties by enforcing only part of the penalty clause, say \$16,000, which would pay the \$10,000 in conventional damages and \$6,000 in additional "penalties," \$1,000 of which might represent the premium paid for the penalty clause, which is being only partly enforced. Such an award would allow the breaching party to retain an incentive (of \$4,000) to reallocate its resources while compelling it to share some of its new gains with the victim of breach, thus at least partially compensating the victim for subjective injuries that might not normally be compensable under market-based measures for damages, but for which the party bargained.

Indeed, if the court believed that the victim of breach would suffer such subjective injury that complete deterrence of breach was a legitimate end of bargaining, the court might enforce the penalty clause in its entirety, eliminating the incentive for reallocating resources. This result could be justified on the basis that the alternative use for the breaching party's resources was not a higher use when taking into consideration the subjective needs of the victim of breach. For

211 See *supra* at notes 165-79 and accompanying text.

example, if the band to whose music the wedding couple fell in love repudiates one day before the wedding, a conventional market-based measure of compensatory damages might bring an award of only \$1,000, representing the additional funds, beyond the canceled fee to the first band, needed to hire on short notice a band that the market would find to be comparable. If a court credited the notion, however, that compensatory damages, especially as measured by the market, could not substitute for actual performance in these circumstances, it might find that a breach would not be efficient. In other words, it might find that – by negotiating the penalty clause – the parties had honestly and reasonably defined the unusual subjective value of the band to the wedding event so that it not only exceeded the value that the general market would place on that performance but also exceeded the value of the band’s performance to the alternative client.

If the rules regarding enforcement of penalties are to influence the actions of the parties before performance or breach, however, they must be predictable. A party who receives a more valuable offer before its performance is due may decide to perform or breach the first contract depending on its ability to predict whether a court will enforce a penalty clause fully, partially, or not at all. In some cases, the prediction may not be difficult. For example, case law in a jurisdiction may establish that courts recognize the great subjective value of certain kinds of performances with sentimental meaning to a wedding party and – subject only to due process constraints – will fully respect a wedding couple’s negotiation of a penalty designed to deter breach, even if in the absence of a penalty clause the case law would neither define compensatory damages so expansively nor permit a jury to award punitive damages.

The parties would not need to depend on the development of predictable lines of authority in various contexts, however, if the jurisdiction applies a rule of always fully enforcing any penalty clause freely negotiated without overreaching and falling within a range that is consistent with the public interest²¹² and is proportionate to the legitimate interests of the parties to satisfy special needs to ensure performance and to signal an elevated commitment to perform in exchange for a premium. Such an approach would not necessarily deter efficient breach; instead, it would help internalize the full costs associated with breach and force the breaching party to negotiate with the victim of breach. If circumstances have not changed, and the victim of the breach truly places a higher value on performance than is reflected by additional profits available from a competing opportunity, then a negotiated settlement is unlikely (and indeed the breach is not even “efficient” as viewed from the nonbreaching party’s subjective valuations), and the contracting party likely will perform rather than breach. On the other hand, if a share the profits from a competing opportunity would more than fully compensate the nonbreaching party for even their subjective sense of loss, or if circumstances and their valuations have changed, the parties likely will reach an agreement sharing the gains of breach with the nonbreaching party, in

212 The public interest might come into play, for example, if the competing opportunity for the potentially breaching party is one that would not go forward without that party and is one that would bring benefits to the entire community. In such a case a court might not honor the nonbreaching party’s full subjective valuations and could appropriately reduce the penalty clause to a point that rewarded reallocation of the breaching party’s resources, even after payment of the penalty. If such an approach was made predictable by statute or case law, the breaching party might be encouraged to breach and reallocate its resources, or the nonbreaching party might be encouraged to negotiate a release at a price that removes any disincentive for such reallocation.

place of enforcement of the penalty clause after possible judicial modification.

To return to the example of the wedding party above, if the musical group could accurately predict that a court would fully enforce the penalty clause, it would not breach the contract unless it thought that the wedding couple would not assert its rights or unless it obtained a release from the wedding couple. In negotiations for a release, the wedding couple could reassess the value of the band's performance in light of their own current circumstances and could determine whether voluntary payment by the band of less than the full penalty would fully assuage the couple's sense of injury. If so, and if the modified penalty were low enough to permit the band to make an increased profit in the new enterprise after paying the penalty, the band could obtain a voluntary release from the wedding couple, thus preserving their goodwill and rebutting any argument that the couple's damages are not fully redressed, while retaining an incentive to reallocate their musical resources to a more valuable use. If the couple refused to grant a release for a sum acceptable to the band, then the couple is placing a subjective value on the performance that makes the wedding the most valuable place to allocate the band's resources, so that breach would not be efficient, at least as defined by the wedding couple's subjective valuations.

In the absence of a penalty clause, the law would be reluctant to recognize subjective valuation to this extent and likely would find the breach to be efficient from the perspective of the marketplace. When the parties themselves have credited those subjective valuations by freely negotiating a penalty clause, however, the courts should take a cue from the French approach and

honor their agreement. Although other players in the market might assess the relatively values differently, enforcing the clause permits the parties to this agreement to maximize their utilities. Moreover, in the event that a substantial public interest might be served by a reallocation of the band's resources, and if it were predictable that a court would accordingly reduce the penalty clause to a point below that which would recognize the couple's subjective valuations,²¹³ then the parties likely would consider that factor in their negotiations of a release, increasing the possibility of a settlement and release.

Of course, the transaction costs of negotiating a release must be added to each party's calculus. However, if the penalty clause were not enforceable, then the parties could easily dispute the amount of compensatory damages that would be owed for breach. The transaction costs of litigating that issue or negotiating a settlement likely would be at least as great as that of negotiating a release from a penalty clause to permit efficient breach.

C. Comparison with a Proposal to Liberalize Compensatory Damages

One may argue that parties would freely negotiate a penalty clause only when subjective valuations on performance would make market-based compensatory damages an inadequate substitute for actual performance, and that this inadequacy could be addressed more directly by expanding compensatory damages²¹⁴ to fully redress subjective injuries, at least when the

213 *See id.* and accompanying text.

214 For an outline of limitations on recovery of damages for breach of contract, *see supra* note 202.

circumstances giving rise to special injuries are communicated to the other party so that the injuries are foreseeable. This approach, too, has some merit. If the parties are aware of the subjective value of a performance during bargaining, and if the law predictably awards compensatory damages based on the full subjective value, the obligor can determine the fee that will cover the risk of nonperformance and liability for disappointed expectations based on full subjective valuation. If the fee is a deal-breaker, the obligee may need to sacrifice the availability of this fulsome measure of damages by agreeing to a liquidated damages clause that limits compensatory damages to a more conventional measure and that allows the obligor to lower its price.

Simply expanding the availability of nonmarket-based or nonpecuniary losses, however, will not help the members of our wedding party if they are not confident of their ability to persuade the band members at the time of breach of the full extent of their injuries, or of their ability to prove those subjective injuries to a court. Moreover, expanding the definition of recoverable compensatory damages might inject sufficient uncertainty into the consequences of bargaining as to have a chilling effect on contract formation, even on the negotiation of some bargains to which the expansive definition would not ultimately apply.

Consequently, the better approach would retain current default rules concerning compensatory damages, allowing the parties to depart from those rules by explicitly agreeing to stipulated damages. If the stipulated damages exceed the normal measure of compensatory damages, they might be viewed as compensation supplemented by a penalty, consistent with the

previous discussion in this section, or they might be viewed as liquidated compensatory damages with a stipulation that reflects agreement to expand the normal range of compensable injuries. The distinction would be largely semantic, although some courts might find one framework to be a more palatable departure from the current regime than the other.

However the damages are characterized, enforcement of the penalty or expanded compensation would not depart from a general rule against extracompensatory damages much more than the current rule that allows enforcement of prospectively reasonable liquidated damages that exceed the damages that are actually sustained. In both cases, deference to the parties' voluntary agreement concerning damages permits a departure from the damages that would be available in that absence of such agreement.

IV. Conclusion

Although the common law achieves apparent consistency in refusing both to enforce contractual penalty clauses and to award punitive damages for breach of contract in the absence of such a clause, the French experience shows that the two cases can be distinguished in a principled manner. Even if a legal system adheres to a general rule against punitive damages for breach of contract, it can justify cautious enforcement of a freely negotiated penalty clause in the name of respecting the autonomy of the parties, permitting them to achieve an economically efficient result through an obligor signaling an unqualified commitment to perform and the obligee paying a premium for a highly valued assurance of performance.