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# AN AUSTRIAN PERSPECTIVE ON THE LAW OF LIQUIDATED DAMAGES: THE CASE FOR AN ALL-ENFORCEMENT RULE\*

## I. INTRODUCTION

At common law, courts will not enforce liquidated damages clauses unless the stipulated sum bears a reasonable relation to either the anticipated or actual losses that result from breach. Penalty clauses, intended to compel performance, are per se unenforceable. Commentators have set forth arguments both for and against this common-law rule on the basis of efficiency.

One of the main principles of Austrian economics is the subjective theory of value, the idea that value is subjective to each individual and cannot be objectively measured. It follows logically from the theory of value subjectivism that interpersonal and inter-temporal utility comparisons cannot be made. This Comment employs the principles of Austrian economics to demonstrate that efficiency based arguments are ill suited for choosing among alternative legal rules and informing the judicial decision-making process. It also uses Austrian welfare economics to disprove the necessity of paternalistic judicial interventions that inevitably attend the enforcement of the current law. Finally, this Comment proposes an alternative legal rule, based on the title-transfer theory of contracts, which allows for the enforcement of liquidated damages provisions irrespective of reasonableness.

Part II reviews the current law of liquidated damages, discusses a number of efficiency-based arguments for and against enforcement of liquidated damages provisions, and provides a succinct overview of Austrian economic principles that are relevant to this discussion. Part III discusses the problems with efficiency-based considerations and the current law of liquidated damages, provides an alternative legal framework from which an all-enforcement rule may be derived, and discusses the application of the all-enforcement rule with reference to real-world examples.

## II. OVERVIEW

This overview lays out the relevant legal background and surveys a number of efficiency arguments for and against the enforcement of liquidated damages provisions. A brief primer on Austrian economics and a discussion of commonly employed efficiency criteria are also included to assist readers who are unfamiliar with these economic principles. Finally, a summary of the title-transfer theory of contracts is provided.

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A. *The Just Compensation Principle*

Under the common law of contracts, the general remedy for breach of contract is the award of expectation damages.<sup>1</sup> Expectation damages are designed to give the nonbreaching party “the benefit of his bargain by awarding him a sum of money that will, to the extent possible, put him in as good a position as he would have been in had the contract been performed.”<sup>2</sup> Contract damages are limited, however, by the actual loss sustained by the nonbreaching party<sup>3</sup> and cannot place the injured party in a better position than he would have been had performance been rendered.<sup>4</sup> This is the principle of just compensation, the idea that the law will only award damages for “the loss or injury actually sustained.”<sup>5</sup>

In keeping with the principle of just compensation, punitive damages are generally not available in breach-of-contract actions.<sup>6</sup> A narrow exception exists in some jurisdictions that allow the award of punitive damages for bad-faith breaches of insurance contracts.<sup>7</sup> However, courts have not extended this exception to other types of contracts;<sup>8</sup> and to recover punitive damages in breach-of-contract cases, plaintiffs must prove the existence of an independent tort for which punitive damages are allowed.<sup>9</sup>

Damages that are unforeseeable or incapable of determination with reasonable certainty are likewise unrecoverable.<sup>10</sup> In addition, damages for mental distress caused

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1. See RESTATEMENT (SECOND) OF CONTRACTS § 347 (1981) (providing that “the injured party has a right to damages based on his expectation interest”).

2. *Id.* cmt. a; see also *BVT Lebanon Shopping Ctr., Ltd. v. Wal-Mart Stores, Inc.*, 48 S.W.3d 132, 136 (Tenn. 2001) (holding that diminution in value is the appropriate measure of damages for anchor store’s breach of covenant of continuous occupancy because it “best serves the objective of protecting the [shopping center’s] expectation interest”).

3. RESTATEMENT (SECOND) OF CONTRACTS § 347 cmt. e.

4. *E.g.*, *BVT Lebanon*, 48 S.W.3d at 136.

5. *Curran v. Williams*, 89 N.W.2d 602, 604 (Mich. 1958) (emphasis omitted) (quoting *Jaquith v. Hudson*, 5 Mich. 123 (1858)).

6. See, *e.g.*, *Miller Brewing Co. v. Best Beers of Bloomington, Inc.*, 608 N.E.2d 975, 981 (Ind. 1993) (holding that there are no exceptions to the general rule that punitive damages are not available in breach-of-contract actions).

7. *E.g.*, *Tackett v. State Farm Fire & Cas. Ins. Co.*, 653 A.2d 254, 256 (Del. 1995) (indicating that punitive damages may be available for “intentional or malicious breach” of insurance contract).

8. See, *e.g.*, *E.I. DuPont de Nemours & Co. v. Pressman*, 679 A.2d 436, 448 (Del. 1996) (declining to allow punitive damages for breach of employment contracts).

9. *E.g.*, *Zapata Sucesores Hermanos, S.A. v. Hearthside Baking Co.*, 313 F.3d 385, 390 (7th Cir. 2002) (explaining that to recover punitive damages outside the insurance context, “plaintiff must show that the breach of contract involved tortious misconduct, such as duress or fraud or abuse of fiduciary duty”); *Miller Brewing*, 608 N.E.2d at 981 (stating that punitive damages are unavailable unless the breaching party’s conduct constitutes an independent tort for which punitive damages may be awarded).

10. See RESTATEMENT (SECOND) OF CONTRACTS § 351(1) (1981) (“Damages are not recoverable for loss that the party in breach did not have reason to foresee as a probable result of the breach when the contract was made.”); *id.* § 352 (“Damages are not recoverable for loss beyond an amount that the evidence permits to be established with reasonable certainty.” (minor typographical errors corrected)).

by nonperformance are prohibited under most circumstances.<sup>11</sup> The foreseeability limitation protects the breaching party from being held liable for losses that he had no reason to expect to result from breach.<sup>12</sup> Thus, the foreseeability limitation can be viewed as protecting the reasonable expectations of the breaching party, and, as such, is consistent with the principle of just compensation. The reason for not allowing recovery of damages for mental disturbance is that such damages “are often particularly difficult to establish and to measure,”<sup>13</sup> and “[t]he law . . . may *not* therefor enter into the domain of speculation or conjecture.”<sup>14</sup>

Like common-law remedies, remedies under the Uniform Commercial Code (U.C.C.) are intended to restore the nonbreaching party to the position he would have occupied if the contract had been performed.<sup>15</sup> For example, U.C.C. section 2-708, which governs the measure of damages to which a seller is entitled in the event of nonacceptance or repudiation by the buyer, provides as follows:

(1) Subject to subsection (2) . . . the measure of damages for non-acceptance or repudiation by the buyer is the difference between the market price at the time and place for tender and the unpaid contract price . . . but less expenses saved in consequence of the buyer’s breach.

(2) If the measure of damages provided in subsection (1) is inadequate to put the seller in as good a position as performance would have done then the measure of damages is the profit (including reasonable overhead) which the seller would have made from full performance by the buyer . . .<sup>16</sup>

If the seller is able to resell the goods on the open market, he is entitled to a measure of damages equivalent to the difference between the contract price and market price.<sup>17</sup> If for some reason, however, the seller is unable to resell the goods, the aforementioned measure of damages would be inadequate to fully compensate him, and he would instead be entitled to lost profits under subsection (2).<sup>18</sup>

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11. *See id.* § 353 (“Recovery for emotional disturbance will be excluded [unless] the breach also caused bodily harm or the contract or the breach is of such a kind that serious emotional disturbance was a particularly likely result.”).

12. *Freund v. Wash. Square Press, Inc.*, 314 N.E.2d 419, 420 (N.Y. 1974).

13. RESTATEMENT (SECOND) OF CONTRACTS § 353 cmt. a.

14. *Vickers v. Wichita State Univ.*, 518 P.2d 512, 517 (Kan. 1974) (quoting *States v. Durkin*, 68 P. 1091, 1092 (Kan. 1902)).

15. *Kenco Homes, Inc. v. Williams*, 972 P.2d 125, 128 (Wash. Ct. App. 1999).

16. U.C.C. § 2-708 (2004).

17. *Kenco Homes*, 972 P.2d at 128; *see also Wendling v. Puls*, 610 P.2d 580, 584 (Kan. 1980) (affirming trial court’s calculation of damages, which reflected the difference between the contract price and market price of cattle on the date buyers were required to accept delivery).

18. *Kenco Homes*, 972 P.2d at 128. There are three common situations in which the measure of damages under subsection (1) would be inadequate to fully compensate the seller: (1) where seller was not in possession of the goods at the time of breach and chooses not to acquire them after breach, (2) where the goods “are of such an odd or peculiar nature” that the seller is unable to find another market for them, and (3) where resale of the goods fails to compensate the seller for lost profits because he could have and would have made an additional sale but for the buyer’s breach (“lost volume seller”). *Id.* at 128–29; *see also Rodriguez v. Learjet, Inc.*, 946 P.2d 1010, 1014 (Kan. Ct. App. 1997) (explaining that a lost volume seller is one whose volume of sales is diminished by the buyer’s breach).

## B. *The Law of Liquidated Damages*

When challenged, liquidated damages clauses are subject to substantial judicial scrutiny and will not be enforced if deemed to be *in terrorem* clauses intended to compel performance by imposing a penalty for breach.<sup>19</sup> This Section provides an overview of the law of liquidated damages, both under the common law and the U.C.C.

### 1. Approaches Under the Common Law

#### a. *Two-Pronged Approach*

A number of approaches have been developed for the purpose of distinguishing enforceable liquidated damages provisions from unenforceable penalties. The most common approach is the one delineated by the *Restatement (Second) of Contracts*, and most jurisdictions have adopted either the Restatement approach or a variation thereof. Section 356 of the Restatement provides, in relevant part:

Damages for breach by either party may be liquidated in the agreement but only at an amount that is reasonable in the light of the anticipated or actual loss caused by the breach and the difficulties of proof of loss. A term fixing unreasonably large liquidated damages is unenforceable on grounds of public policy as a penalty.<sup>20</sup>

Courts have interpreted this section of the Restatement as setting forth a two-pronged test, with the first prong being the reasonableness of the stipulated amount and the second prong being the difficulty of ascertaining the amount of damages that would result from breach.<sup>21</sup> Although the Restatement specifically indicates that the reasonableness of the stipulated amount can be determined by reference to either the anticipated damages at the time of contract formation *or* the actual damages caused by the breach,<sup>22</sup> courts are divided on the analyses they apply to determine reasonableness.

Some courts apply a purely prospective analysis, measuring reasonableness *ex ante*, that is, at the time of contract formation.<sup>23</sup> Other jurisdictions follow the

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19. See Charles J. Goetz & Robert E. Scott, *Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach*, 77 COLUM. L. REV. 554, 554–55 (1977).

20. RESTATEMENT (SECOND) OF CONTRACTS § 356 (1981) (minor typographical errors corrected).

21. See, e.g., *Farmers Exp. Co. v. Marfo Co.*, 799 F.2d 159, 162 (5th Cir. 1986); *Valentine's, Inc. v. Ngo*, 251 S.W.3d 352, 354 (Mo. Ct. App. 2008); *Lind Bldg. Corp. v. Pac. Bellevue Devs.*, 776 P.2d 977, 980 (Wash. Ct. App. 1989); see also RESTATEMENT (SECOND) OF CONTRACTS § 356 cmt. b (indicating that under the test delineated in subsection one, whether a liquidated damages provision is an unenforceable penalty depends on two factors: (1) the reasonableness of the stipulated sum in relation to the “anticipated or actual loss caused by the breach” and (2) “difficulty of proof of loss”).

22. RESTATEMENT (SECOND) OF CONTRACTS § 356 cmt. b (“The amount fixed is reasonable to the extent that it approximates the actual loss that has resulted from the particular breach, even though it may not approximate the loss that might have been anticipated under other possible breaches. . . . Furthermore, the amount fixed is reasonable to the extent that it approximates the loss anticipated at the time of the making of the contract, even though it may not approximate the actual loss.”).

23. E.g., *Mech. Air Eng'g Co. v. Totem Constr. Co.*, 801 P.2d 426, 428 (Ariz. Ct. App. 1989) (stating that the stipulated amount must be a “reasonable forecast of just compensation” for breach); *Carrothers Constr. Co. v. City of S. Hutchinson*, 207 P.3d 231, 243 (Kan. 2009) (holding that prospective analysis is the sole basis for determining the reasonableness of a liquidated damages provision); *Barrie Sch. v. Patch*, 933 A.2d 382,

Restatement's formula and take a prospective-retrospective approach, permitting "a showing of ex post reasonableness to save the clause."<sup>24</sup> These jurisdictions will find enforceability if the stipulated amount in the clause is reasonable in relation to either the anticipated *or* actual damages.<sup>25</sup>

A final group of jurisdictions that apply the two-pronged test also employ a prospective-retrospective analysis. However, these jurisdictions, unlike the ones that follow the Restatement's formulation, require that the stipulated amount be reasonably proportionate to both the anticipated *and* actual damages.<sup>26</sup>

*b. Three-Pronged Approach*

A minority of jurisdictions employ a three-pronged test to determine the validity of liquidated damages provision. The main difference between the three-pronged approach and the two-pronged approach is that the former requires courts to explicitly consider the parties' intent in addition to the reasonableness of the stipulated amount and the difficulty of estimating potential damages.<sup>27</sup> In *Caincare, Inc. v. Ellison*,<sup>28</sup> the court explained that

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389 (Md. 2007) (indicating that in the absence of statutory provisions to the contrary, the reasonableness of liquidated damages provisions is to be measured at the time the contract was made); *Kelly v. Marx*, 705 N.E.2d 1114, 1116 (Mass. 1999) (concluding that in determining the enforceability of a liquidated damages provision, a court "should examine only the circumstances at contract formation"); *Wallace Real Estate Inv. Inc. v. Groves*, 881 P.2d 1010, 1015 (Wash. 1994) (explaining that Washington case law requires both reasonableness and the difficulty of estimating damages to be assessed at the time of contract formation).

24. *XCO Int'l Inc. v. Pac. Scientific Co.*, 369 F.3d 998, 1007 (7th Cir. 2004) (applying Illinois law). The prospective-retrospective analysis is sometimes referred to as the second-look approach because courts applying this approach will take a second look at the time of breach to determine reasonableness. *See, e.g., Kelly*, 705 N.E.2d at 1115 (rejecting the second-look approach).

25. *E.g., Farmers Exp. Co. v. Marfo Co.*, 799 F.2d 159, 162, 165 (5th Cir. 1986) (following the Restatement's formula and finding a liquidated damages provision enforceable under general maritime law); *Kealy v. Harter*, 682 F.2d 198, 200 (8th Cir. 1982) (applying Nebraska law and following the Restatement's formula); *Princess Hotels, Int'l Inc. v. Del. State Bar Ass'n*, No. 95C-01-062, 1997 Del. Super. LEXIS 560, at \*8 (Oct. 27, 1997) (stating that for a liquidated damages clause to be enforceable, damages must be difficult to ascertain and the stipulated amount must be reasonably proportionate to either the estimated or actual damages); *E. Carolina Internal Med. v. Faidas*, 564 S.E.2d 53, 56 (N.C. Ct. App. 2002) (indicating that the second prong of the enforceability test would be satisfied if the stipulated amount was reasonable in relation to the estimated or anticipated damages).

26. *E.g., Vanderbilt Univ. v. Dinardo*, 174 F.3d 751, 755 (6th Cir. 1999) (providing that under Tennessee law a liquidated damages provision will only be enforceable "if it is reasonable in relation to the anticipated damages for breach, measured prospectively at the time the contract was entered into, and not grossly disproportionate to the actual damages"); *Mattingly Bridge Co. v. Holloway & Son Constr. Co.*, 694 S.W.2d 702, 705 (Ky. 1985) (stating that if liquidated damages "exceeds any reasonable limitation by either" anticipated or actual loss, it is unenforceable).

27. *E.g., Am. Car Rental, Inc. v. Comm'r of Consumer Prot.*, 869 A.2d 1198, 1206 (Conn. 2005) (stating that for a liquidated damages provision to be enforceable, three conditions must be met: (1) uncertainty in or difficulty of proving damages, (2) "intent on the part of the parties to liquidate damages in advance," and (3) a stipulated amount reasonably proportionate to anticipated loss); *Leahy Realty Corp. v. Am. Snack Foods Corp.*, 625 N.E.2d 956, 964 (Ill. App. Ct. 1993) (noting that Illinois courts will enforce a liquidated damages provision in a "real estate contract when: (1) the parties intended to agree in advance to the settlement of damages that might arise from the breach; (2) the amount of liquidated damages was reasonable at the time of contracting . . . and (3) actual damages would be uncertain in amount and difficult to prove"); *Wassenaar v.*

a liquidated damages clause is enforceable if (1) the injury caused by the breach of the contract is difficult or impossible to accurately estimate; (2) the parties intended to provide for damages rather than a penalty; and (3) the sum stipulated upon by the parties is a reasonable pre-estimate of the probable loss.<sup>29</sup>

It is unclear whether the addition of this third factor has any substantive effect on the application of the test because most courts do not explain how the intention of the parties is ascertained.<sup>30</sup> The *Caincare* court looked to the contractual language to determine the parties' intent, concluding that because the agreement refers to the stipulated sum as "liquidated damages," the parties must have intended "for the damages to be liquidated."<sup>31</sup> Other courts, however, have expressed skepticism about placing too much weight on the label employed by the parties.<sup>32</sup> Additionally, a number of jurisdictions employing a two-pronged approach also consider the intention of the parties to be important.<sup>33</sup> The difference between these jurisdictions and those that employ a three-pronged approach is likely to be negligible.

Finally, it is worth noting that although the language of the three-pronged test suggests that reasonableness of the stipulated amount is to be assessed *ex ante* and that the amount need only be reasonable in relation to anticipated damages, some courts nonetheless determine reasonableness in reference to both anticipated *and* actual damages.<sup>34</sup> Thus, as with jurisdictions employing two-pronged tests, jurisdictions employing three-pronged tests are likewise divided on the relevant time for assessing reasonableness.

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Panos, 331 N.W.2d 357, 362–63 (Wis. 1983) (setting forth a three-factor reasonableness test where one factor was the intention of the parties).

28. 612 S.E.2d 47 (Ga. Ct. App. 2005).

29. *Caincare*, 612 S.E.2d at 50.

30. For example, in *Wassenaar*, the Wisconsin Supreme Court, after enumerating the three factors of its reasonableness test, proceeded to dismiss the factor of the parties' intent by pointing out that this factor has generally been omitted from recent discussions of the validity of liquidated damages clauses "because subjective intent has little bearing on whether the clause is objectively reasonable." *Wassenaar*, 331 N.W.2d at 363.

31. *Caincare*, 612 S.E.2d at 50.

32. See *Am. Car Rental*, 869 A.2d at 1206 (explaining that whether the label "liquidated damages" or "penalty" is used is not dispositive); *Wassenaar*, 331 N.W.2d at 363 ("The label the parties apply to the clause, which might indicate their intent, has some evidentiary value, but it is not conclusive.").

33. *E.g.*, *Barrie Sch. v. Patch*, 933 A.2d 382, 389 (Md. 2007) (stating that "the decisive element is the intention of the parties—whether they intended that the sum be a penalty or an agreed-upon amount as damages in case of a breach" (quoting *Bd. of Educ. v. Heister*, 896 A.2d 342, 352 (Md. 2006))). *But see, e.g.*, *In re Exemplar Mfg. Co.*, 331 B.R. 704, 714 (Bankr. E.D. Mich. 2005) ("Under Michigan law, '[w]hether [a liquidated damage] clause [is] a valid and enforceable one for stipulated damages, or [is] invalid as a penalty . . . is a question of law and there is no need for an inquiry into the intent of the parties.'" (alterations and omission in original)).

34. See, *e.g.*, *Shallow Brook Assocs. v. Dube*, 599 A.2d 132, 137 (N.H. 1991) (noting that although the language of the three-pronged test implies that reasonableness and proportionality are measured with reference to estimated loss at the time of contracting, "cases decided by this court . . . have looked to a party's *actual* loss, as well as *presumable* loss, to resolve the question of reasonableness"); *Lake Ridge Acad. v. Carney*, 613 N.E.2d 183, 188 (Ohio 1993) (applying three-pronged test and requiring the provision to be reasonable at the time of contract formation and in relation to actual damages).

c. *Underliquidation and Liability Limitation Provisions*

It is interesting to note that although comment a to section 356 of the *Restatement* states that “[a] term that fixes an unreasonably small amount as damages may be unenforceable as unconscionable,”<sup>35</sup> courts rarely strike down clauses in which damages are underliquidated.<sup>36</sup> Additionally, courts routinely enforce liability limitation clauses, requiring only that the clause be “[c]lear, unambiguous, unmistakable, and conspicuous” and that it provide effective notice of the release of liability to the other party.<sup>37</sup> There is no reasonableness requirement because liability limitations are not penalties since “the damages fixed are not disproportionately large.”<sup>38</sup> Where the contract is between sophisticated commercial parties and “damages are economic, courts rarely find that liability limitations are unconscionable.”<sup>39</sup>

In *Donegal Mutual Insurance Co. v. Tri-Plex Security Alarm Systems*,<sup>40</sup> the Superior Court of Delaware upheld a contractual provision limiting the liability of a fire alarm installer on the grounds that the language of the provision was clear and written in “plain bold type.”<sup>41</sup> When the plaintiff argued that the clause was a liquidated damages provision, the court noted that in cases involving sophisticated commercial parties, “there is no difference between a liquidated damages clause . . . and a liability limitation clause.”<sup>42</sup>

Courts have not uniformly upheld liability limitation clauses, however. In *Samson Sales, Inc. v. Honeywell, Inc.*,<sup>43</sup> the Ohio Supreme Court invalidated a similar provision that limited the liability of an alarm installer as an unenforceable penalty.<sup>44</sup> The court explained that damages were readily ascertainable, the stipulated amount was “manifestly disproportionate” to anticipated damages, and that it was “beyond comprehension” that the parties would have intended to limit damages to such a small amount.<sup>45</sup>

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35. RESTATEMENT (SECOND) OF CONTRACTS § 356 cmt. a (1981).

36. See *Barrie Sch.*, 933 A.2d at 389 (Md. 2007) (explaining that if the stipulated amount is inadequate to fully compensate the nonbreaching party, a greater amount cannot be recovered because the parties are bound by the agreement to recover liquidated damages in lieu of actual damages); *Naporano Assocs. v. B & P Builders*, 706 A.2d 1123, 1129 (N.J. Super. Ct. App. Div. 1998) (reversing trial court’s award of actual damages and holding the liquidated damages provision was reasonable even though actual damages significantly exceeded the stipulated amount).

37. *Purcell Tire & Rubber Co. v. Exec. Beechcraft, Inc.*, 59 S.W.3d 505, 509 (Mo. 2001); see also *Donegal Mut. Ins. Co. v. Tri-Plex Sec. Alarm Sys.*, 622 A.2d 1086, 1089 (Del. Super. Ct. 1992) (indicating that an “overwhelming number of courts” have upheld liability limitation clauses); *Lobianco v. Prop. Prot., Inc.*, 437 A.2d 417, 421 (Pa. Super. Ct. 1981) (upholding liability limitation clause in a security alarm contract under the U.C.C.).

38. *Purcell Tire*, 59 S.W.3d at 510.

39. *Id.* at 510.

40. 622 A.2d 1086 (Del. Super. Ct. 1992).

41. *Donegal Mut. Ins.*, 622 A.2d at 1090.

42. *Id.* at 1089.

43. 465 N.E.2d 392 (Ohio 1984).

44. *Samson Sales*, 465 N.E.2d at 394.

45. *Id.* The *Samson* court employed a three-pronged test. *Id.*

## 2. The Uniform Commercial Code

Section 2-718 of the Uniform Commercial Code (U.C.C.) governs the enforceability of liquidated damages clauses in contracts for the sale of goods.<sup>46</sup> Section 2-718 provides, in relevant part:

Damages for breach by either party may be liquidated in the agreement but only at an amount which is reasonable in the light of the anticipated or actual harm caused by the breach, the difficulties of proof of loss, and the inconvenience or nonfeasibility of otherwise obtaining an adequate remedy.<sup>47</sup>

An early opinion that discussed section 2-718 is the New York case of *Equitable Lumber Corp. v. IPA Land Development Corp.*<sup>48</sup> There, the New York Court of Appeals interpreted section 2-718 as delineating a prospective-retrospective analysis, requiring reasonableness only with respect to either anticipated *or* actual damages.<sup>49</sup> The court further explained that once a liquidated damages provision satisfies the reasonableness requirement under the first sentence of section 2-718(1), the “provision may nonetheless be invalidated under the last sentence of the section if it is so unreasonably large that it serves as a penalty rather than a good faith attempt to pre-estimate damages.”<sup>50</sup> Under this interpretation, section 2-718(1) sets forth two requirements for enforceability: (1) that the stipulated amount be reasonable and (2) that it not be so unreasonably large as to be deemed a penalty.<sup>51</sup>

In the 1991 case of *Kvassay v. Murray*,<sup>52</sup> where the seller sued buyers to recover liquidated damages for breach of a sale-of-goods contract,<sup>53</sup> the Kansas Court of Appeals distinguished the enforceability test under the U.C.C. from the common-law test.<sup>54</sup> The court explained that the common-law test involved two prongs, requiring that the stipulated amount be reasonable and that damages be difficult to ascertain, whereas “[u]nder the UCC . . . reasonableness is the only test.”<sup>55</sup> It then enumerated the three criteria for assessing reasonableness under the U.C.C.: “(1) anticipated or actual harm caused by breach; (2) difficulty of proving loss; and (3) difficulty of obtaining an adequate remedy.”<sup>56</sup> Comparing the stipulated amount to the seller’s projected profits, the court concluded that the liquidated amount appeared unreasonable in light of

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46. U.C.C. § 2-718 (2004).

47. *Id.* § 2-718(1).

48. 344 N.E.2d 391 (N.Y. 1976).

49. *Equitable Lumber Corp.*, 344 N.E.2d at 395.

50. *Id.*

51. For a critique of the New York court’s interpretation of section 2-718(1), see Gregory Scott Crespi, *Measuring “Actual Harm” for the Purpose of Determining the Enforceability of Liquidated Damages Clauses*, 41 HOUS. L. REV. 1579, 1591–93 (2005).

52. 808 P.2d 896 (Kan. Ct. App. 1991).

53. *Kvassay*, 808 P.2d at 899.

54. *Id.* at 900.

55. *Id.*

56. *Id.* The court reiterated this test in *Rodriguez v. Learjet, Inc.*, 946 P.2d 1010, 1013 (Kan. Ct. App. 1997).

anticipated damages<sup>57</sup> but indicated that the clause could be saved if it were found to be reasonable in relation to actual damages.<sup>58</sup>

C. *To Enforce or Not to Enforce? The Efficiency Arguments.*

A number of scholars have used efficiency considerations to argue for<sup>59</sup> and against<sup>60</sup> the enforcement of liquidated damages provisions in which the stipulated amount might be deemed unreasonable or punitive. This Section surveys the theories set forth to support efficiency arguments on both sides of the debate.

1. The Most-Efficient-Insurer Model

Professors Goetz and Scott point out that the just compensation principle of modern contract law is often difficult to implement when the nonbreaching party attaches an “idiosyncratic value” to the promised performance, which is not reflected in its market value.<sup>61</sup> Compensatory contract damages will generally fail to compensate the injured party for the loss of this idiosyncratic value because the value of the promised performance will usually be assessed by reference to an external market, such that the measure of damages would be limited to the market value of the performance.<sup>62</sup> Even if the “‘value to the owner’ is substituted” for market value, “any ‘fanciful or sentimental’ value” will not be recoverable on the grounds that it is too uncertain and incapable of measurement.<sup>63</sup> Thus, where the nature of the contract and/or the existence of idiosyncratic value render potential losses from breach uncertain or difficult to estimate, parties are likely to negotiate liquidated damages provisions to protect their interests.<sup>64</sup> However, the current law of liquidated damages encourages the breaching party to challenge the validity of such provisions, with the obvious consequence of increasing transaction costs.<sup>65</sup>

Goetz and Scott argue that the enforcement of liquidated damages provisions enhances efficiency by reducing transaction costs and error costs produced by miscalculation of damages that are uncertain or not provable.<sup>66</sup> Moreover, the promisor

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57. The court found that the stipulated amount exceeded anticipated losses by either 16.5% or 41%, depending on how the expected profits were calculated. *Kvassay*, 808 P.2d at 901.

58. *Id.*

59. See generally Larry A. DiMatteo, *A Theory of Efficient Penalty: Eliminating the Law of Liquidated Damages*, 38 AM. BUS. L.J. 633 (2001); Goetz & Scott, *supra* note 19; Aristides N. Hatzis, *Having the Cake and Eating It Too: Efficient Penalty Clauses in Common and Civil Contract Law*, 22 INT’L REV. L. & ECON. 381 (2003).

60. See generally Kenneth W. Clarkson et al., *Liquidated Damages v. Penalties: Sense or Nonsense?*, 1978 WIS. L. REV. 351 (1978); Paul H. Rubin, *Unenforceable Contracts: Penalty Clauses and Specific Performance*, 10 J. LEGAL STUD. 237 (1981).

61. Goetz & Scott, *supra* note 19, at 570. Goetz and Scott define idiosyncratic value as including “any subjective or ‘fanciful’ valuation which varie[s] significantly from the established market value.” *Id.*

62. *Id.* at 572.

63. *Id.* at 572–73.

64. *Id.* at 574.

65. *Id.* at 575–76. Transaction costs in this case include costs of negotiating the contract and costs of any subsequent litigation initiated to attack the validity of the agreement. *Id.*

66. *Id.* at 578.

is the “most efficient insurer” of his own performance because he is in the best position both to assess the probability of nonperformance and to take measures to reduce that probability.<sup>67</sup>

## 2. The Theory of Efficient Penalties

Professor DiMatteo proposes a theory of efficient penalties to support the enforcement of liquidated damages clauses.<sup>68</sup> An efficient penalty is a penalty that is not large enough to deter efficient breach but is able to force the breaching party to share his gains with the nonbreaching party.<sup>69</sup> An inefficient penalty, on the other hand, is one that produces inefficient performance.<sup>70</sup> The argument is that, when parties have negotiated an inefficient penalty, the appearance of an opportunity for efficient breach induces the promisor to renegotiate with the promisee and adjust the payment for breach to a level that is efficient, that is, one that allows both the promisor and the promisee to benefit from the breach.<sup>71</sup> An efficient penalty thereby provides a fairer result by distributing the utility gains that result from breach between the breaching and nonbreaching parties without sacrificing total utility.<sup>72</sup>

Given that the nonbreaching party likely paid a premium for the liquidated damages provision, non-enforcement of the provision could inflict a reverse penalty on him.<sup>73</sup> Since the nonbreaching party will be unable to recover this premium, which will not be included in the measure of damages, he will not be fully compensated by the award of any legally recognized “actual damages.”<sup>74</sup> The breaching party, on the other hand, will receive a windfall.<sup>75</sup> To encourage efficient penalties and avoid inflicting a reverse penalty on the nonbreaching party, Professor DiMatteo suggests replacing the lower reasonableness standard currently used to assess the enforceability of liquidated damages provisions with the more stringent standard of unconscionability.<sup>76</sup>

## 3. Incentives for Breach Inducement

In a 1978 article, Professors Clarkson, Miller, and Muris propose an efficiency-based justification for the common law’s distinction between enforceable liquidated damages provisions and unenforceable penalties.<sup>77</sup> They argue that the existence of a penalty clause encourages the promisee to engage in breach-inducing activities because breach by the promisor will put the promisee in a better position than he would be in if performance were rendered.<sup>78</sup> The possibility of breach inducement by the promisee

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67. *Id.* at 578–83.

68. DiMatteo, *supra* note 59, at 695.

69. *Id.* at 695–96.

70. *Id.* at 696.

71. *Id.*

72. *Id.* at 697.

73. *Id.* at 697–98.

74. *Id.* at 698–99.

75. *Id.* at 699.

76. *Id.* at 716–18.

77. Clarkson et al., *supra* note 60, at 366–68.

78. *Id.* at 368–70.

leads the promisor to expend resources on detecting and preventing inducement.<sup>79</sup> Thus, penalty clauses produce inefficient outcomes by encouraging contracting parties to waste resources on unproductive activities.<sup>80</sup> However, this sort of inefficiency only becomes a substantial problem when the contract in question is one that provides the promisee with an opportunity to induce breach and where inducement would be difficult to detect.<sup>81</sup> This would be the case in contracts where performance depends in part on the promisee's cooperation.<sup>82</sup>

Based on these principles, Clarkson, Miller, and Muris conclude that where the contract provides the promisee with the opportunity and incentive to covertly induce breach, courts should not enforce the liquidated damages provision unless it is reasonable, that is, unless the stipulated amount bears a reasonable relationship to actual damages.<sup>83</sup> On the other hand, where the contract provides either no opportunity or no incentive for the promisee to covertly induce breach, courts should enforce the clause regardless of reasonableness.<sup>84</sup>

#### 4. Third-Party Litigation Costs

Professor Rubin points out that although penalty clauses are efficient with respect to the contracting parties, they are nevertheless inefficient overall because they tend to increase litigation, which imposes social costs on third parties.<sup>85</sup> Penalty clauses increase litigation by encouraging the promisee to claim that a breach has occurred even though it has not, and the complexity of most commercial contracts ensures that there will nearly always be room to litigate whether contractual terms have been completely fulfilled.<sup>86</sup> Additionally, because disputes over whether performance fully satisfied the terms of the contract tend to be "purely factual," resolution of such disputes does not create legal rules with precedential value.<sup>87</sup> Thus, penalty clauses increase litigation, thereby imposing additional costs on society without producing socially valuable judicial precedents.<sup>88</sup>

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79. *Id.* at 370.

80. *Id.*

81. *Id.* at 371. Because "detected inducement would result in nonenforcement of the [liquidated damages] clause," feasible breach-inducing activities must be relatively difficult to detect in order to provide the promisee with sufficient incentive to engage in such activities. *Id.*

82. *Id.*

83. *Id.* at 375. Clarkson, Miller, and Muris identified three common types of liquidated damages clauses that should be enforced only if they are reasonable: (1) clauses providing for per diem damages in case of delay in the completion of a construction contract, (2) forfeiture clauses such as those that provide for forfeiture of deposits in the event of breach, and (3) stipulated damages provisions masquerading as alternative performance contracts. *Id.* at 388–89.

84. *Id.* at 377. Examples of contracts that do not provide incentive or opportunity to induce breach include contracts containing liability limitation clauses, covenants not to compete, contracts between lender and borrower, and post-breach settlement agreements. *Id.* at 383–84.

85. Rubin, *supra* note 60, at 243. Because litigation costs are partially subsidized by society, an increase in litigation imposes additional costs on the public. *Id.* at 240.

86. *See id.* at 244 (providing an illustrative example of how penalty clauses affect parties' incentives under contract).

87. *Id.*

88. *Id.*

*D. Economics*

## 1. A Brief Primer on Austrian Economics

The Austrian school of economics has experienced something of a renaissance in recent years, mostly due to the fact that Austrian economists were among the few who predicted the financial meltdown that occurred in 2008.<sup>89</sup> Methodologically, the Austrian school is unique in its use of praxeological analysis.<sup>90</sup> Praxeology is the science of human action.<sup>91</sup> The fundamental axiom of praxeology is the action axiom—that man acts, that is, he employs means to attain his ends.<sup>92</sup> The principle of methodological individualism is implicit in the action axiom. The statement that “man acts” tells us that praxeology focuses on the actions of individuals, rather than collectives.<sup>93</sup> Methodological individualism is the recognition that “all actions are performed by individuals” and that “a social collective has no existence and reality outside of the individual members’ actions.”<sup>94</sup> Thus, it is through the analysis of individual action that one may come to understand complex social organizations, such as the market.<sup>95</sup>

All of the propositions of Austrian economics can be deduced from the action axiom and a few empirical axioms, such as the existence of natural resources.<sup>96</sup> The deductive approach of the Austrian School stands in stark contrast to other modern schools of economic thought, which have invariably “adopted the epistemology of positivism (now dubbed ‘logical empiricism’ or ‘scientific empiricism’ by its practitioners).”<sup>97</sup> The pervasiveness of positivism in modern thought is largely responsible for the indiscriminate application of the methodological framework appropriate in science and engineering to the social sciences.<sup>98</sup>

One key concept of Austrian economics that is especially relevant to this discussion is the concept of value subjectivism, the idea that the value of a good is subjective (i.e., it exists only in the minds of human actors, rather than objective or

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89. See, e.g., Walter Block, *Austrian Thymologists Who Predicted the Housing Bubble*, LEWROCKWELL.COM (Dec. 22, 2010), <http://www.lewrockwell.com/block/block168.html> (compiling bibliography of Austrian economists who predicted the real estate and stock market collapse).

90. See MURRAY N. ROTHBARD, *MAN, ECONOMY, AND STATE WITH POWER AND MARKET* 72–76 (2d ed. 2009), available at <http://mises.org/books/mespm.pdf> (explaining the relationship between praxeology and Austrian economics).

91. *Id.* at xxiii.

92. *Id.* at 72.

93. LUDWIG VON MISES, *HUMAN ACTION: A TREATISE ON ECONOMICS* 41 (Ludwig von Mises Inst., scholar’s ed. 1998) (1949), available at <http://mises.org/Books/HumanActionScholars.pdf> (“Praxeology deals with the actions of individual men.”).

94. *Id.* at 42.

95. *Id.*

96. See generally *id.* at 11–13, 64–69. A more in-depth discussion of the Austrian method is beyond the scope of this Comment; however, HANS-HERMANN HOPPE, *ECONOMIC SCIENCE AND THE AUSTRIAN METHOD* (1995), available at <http://mises.org/pdf/esam.pdf>, provides such a discussion.

97. MURRAY N. ROTHBARD, *TOWARD A RECONSTRUCTION OF UTILITY AND WELFARE ECONOMICS* 3 (1997), available at <http://mises.org/rothbard/toward.pdf>.

98. *Id.*

intrinsic as an inherent property of the good).<sup>99</sup> Since individuals use goods as means to achieve ends,<sup>100</sup> given a homogenous supply of goods, such as slices of bread, the first unit that the individual acquires will be used to satisfy the most important (or most urgent) end, the second unit will be used to satisfy the second most important end, and so on.<sup>101</sup> If an individual starts off with a certain homogenous supply of goods, such as five slices of bread, and one unit is taken away from him so that he only has four slices left, he will give up the least urgent end that would have been satisfied by that fifth slice of bread.<sup>102</sup> That fifth slice of bread that was taken away from him is called the marginal unit because “[i]t is the unit ‘at the margin.’”<sup>103</sup> The satisfaction one derives from the least important end fulfilled by the marginal unit is the “satisfaction provided by the marginal unit, or the utility of the marginal unit” (i.e., the marginal utility).<sup>104</sup>

Because value and utility are subjective and exist only in the minds of individuals, they cannot be measured.<sup>105</sup> It is possible for a person to say that he values one thing more than another, but it is not possible for him to provide an objective measure of just how much more.<sup>106</sup> This is because there is no objective unit of measurement for either value or utility, both of which are products of the human mind and not physical objects capable of quantification.<sup>107</sup> Thus, whereas ends may be ranked according to one’s subjective valuation, the value that is attached to each end cannot be measured.<sup>108</sup>

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99. See ROTHBARD, *supra* note 90, at 21 (“The original source of value is the ranking of ends by human actors, who then impute value to consumers’ goods, and so on to the orders of producers’ goods, in accordance with their expected ability to contribute toward serving the various ends.”).

100. For example, if I am hungry, I will use a good (bread) to achieve my end (sate my hunger).

101. ROTHBARD, *supra* note 90, at 24. Suppose that the unit of good in concern is \$300 (so that one unit = \$300, and each \$300 unit is indistinguishable from any other so that the units are *homogenous* goods), and further suppose that a law student has a budget of \$1,200 (i.e., he has four units of \$300). He might choose to spend the first \$300 on rent because *to him* that is the most important end (being evicted and having to sleep in the library would be pretty unpleasant), the next \$300 on utilities (he cannot write that law review comment without electricity at home), the third \$300 on food, and the last \$300 on beer, which is subjectively the least important end to the law student. On the other hand, an alcoholic might have the reverse preference scale; he might choose to spend the first \$300 on beer, the next \$300 on food, the third on rent (it would not really make sense to pay for utilities without paying rent), and the last \$300 on utilities. Thus, one sees that exactly which end is more important depends on the subjective valuation of the individual actor; but one thing is for certain—each additional unit of the good will be used to satisfy successively less important ends.

102. *Id.* at 25. Returning to the law student example, if the student is forced to spend \$300 on casebooks during the first month of classes, he will only have \$900 left that month. Thus, given his preference rankings, he will give up the least important end that he would have spent the \$300 on (i.e., beer).

103. *Id.* at 27. In the law student example, the marginal unit would be the \$300 that he was forced to spend on casebooks.

104. *Id.* (emphasis omitted). In the law student example, the marginal utility would be the satisfaction the law student would have derived from the beer that he had to forego. This foregone satisfaction would also be the marginal utility of the \$1,200 (when divided into \$300 units). See *id.* (explaining that “[i]f the marginal unit is one unit, then the *marginal utility of the supply* is the end that must be given up as the result of a loss of the unit”).

105. *Id.* at 18–19.

106. *Id.* at 19.

107. *Id.*

108. *Id.* The law student can rank his preferences (from most valued to least valued) as follows:

1. housing
2. electricity

Since there is no unit of measurement for utility (no such thing as “utiles”), it follows that one cannot perform mathematical operations on utility.<sup>109</sup> Thus, it is also illegitimate to construct utility functions and indifference curves,<sup>110</sup> for the construction of mathematical functions presupposes the existence of an objective and cardinal unit of measurement.<sup>111</sup> Moreover, the construction of continuous mathematical functions presupposes that an infinitesimal change in one variable has a meaningful and detectable effect.<sup>112</sup> Such a presumption is inappropriate in the study of human action because human beings cannot perceive infinitesimal changes.<sup>113</sup> Thus, “human action cannot be predicated upon infinitesimal differences.”<sup>114</sup>

Another corollary to the fact that value and utility cannot be measured is the equally irrefutable fact that interpersonal utility comparisons cannot be made.<sup>115</sup>

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3. food

4. beer

However, one cannot measure the “distance” (or difference) between the values he attaches to one item versus the next. Note that in the hypothetical, each item costs \$300, but they are valued differently, which implies that the utility of the first \$300 (spent on the most highly valued end, the end that gives you the most satisfaction—housing) is not the same as the utility of the last \$300 (spent on the least highly valued end, the end that gives you the least satisfaction—beer). This is the *law of diminishing marginal utility*—the idea that, given a supply of homogenous goods (units of \$300 in the above example), “[t]he greater the supply of a good, the lower the marginal utility; the smaller the supply, the higher the marginal utility.” *Id.* at 27 (emphasis omitted).

109. *Id.* at 19 (providing that “values or utilities cannot be added, subtracted, or multiplied”).

110. See Robert L. Birmingham, *Damage Measures and Economic Rationality: The Geometry of Contract Law*, 1969 DUKE L.J. 49, 53–58, for a discussion of indifference curve analysis.

111. Jeffrey M. Herbener, *The Pareto Rule and Welfare Economics*, 10 REV. AUSTRIAN ECON., no. 1, 1997 at 79, 88 (“To construct social indifference curves, one must presuppose cardinal utility and infinitesimal units of cardinal utility.”). In fairness, it is worth pointing out that modern welfare economists acknowledge that utility is ordinal and not measurable; however, they attempt to circumvent this problem by assigning arbitrary cardinal numbers to indifference curves and then performing mathematical operations on them. *Id.* This, however, is not so much a clever method of circumventing the problem of ordinal utility as it is a means of disguising the use of cardinal utility in welfare economics. See *id.* at 89–90 (explaining that arbitrary assignment of cardinal numbers to indifference curves, rather than avoiding assumption of cardinal utility, actually implies cardinal utility).

112. See, e.g., H. JEROME KEISLER, *ELEMENTARY CALCULUS: AN INFINITESIMAL APPROACH* 125 (2nd ed. 1986), available at <http://www.math.wisc.edu/~keisler/calc.html> (providing that a function,  $f(x)$ , is continuous at point  $c$  if  $f(c)$  is defined and where  $x$  deviates infinitesimally from  $c$ ,  $f(x)$  deviates infinitesimally from  $f(c)$ ).

113. See Herbener, *supra* note 111, at 90 (explaining that because infinitesimal differences are imperceptible, an individual cannot prefer one option over another, imperceptibly different, option).

114. *Id.*

115. ROTHBARD, *supra* note 97, at 22–23; see also Herbener, *supra* note 111, at 79 (explaining that due to subjective nature of utility, “no common cardinal units could possibly exist for the purpose of comparing the utility of different individuals”). Thus, one cannot say that just because, given a supply of \$1,200, the value rankings of the law student are (1) housing, (2) electricity, (3) food, and (4) beer, and the rankings of the alcoholic are (1) beer, (2) food, (3) housing, and (4) electricity, that the alcoholic derives the same amount of utility from beer as the law student does from housing. Indeed, even given two law students, each with a budget of \$1,200 and the exact same value rankings, one still would not be able to say that law student number one derives the same amount of utility from housing as law student number two. The absence of an objective unit of measurement for utility precludes any such interpersonal comparisons.

Because interpersonal utilities cannot be compared, they cannot be summed together; this “prevents economics from saying anything about social utility.”<sup>116</sup>

Demonstrated preference, the principle that an individual’s preferences are revealed by the actual choices that he makes,<sup>117</sup> is another Austrian concept that is important for this analysis. Because means, or resources, are scarce, an individual must choose among the various ends that he wishes to attain with his limited means.<sup>118</sup> Thus, human “[a]ction implies choice among alternatives.”<sup>119</sup> Given a choice among alternative ends, a person will always expend his resources toward the attainment of his most preferred end.<sup>120</sup> For this reason, one can deduce a man’s preference from his action.<sup>121</sup>

The concept of demonstrated preference tells us only “that an action, at a specific point [in] time, reveals part of a man’s preference scale *at that time*.”<sup>122</sup> There is no reason, grounded in either economics or common sense, to assume that an individual’s preference scale would remain constant over time.<sup>123</sup>

Because preference can only be demonstrated through action, it is illegitimate to conduct inter-temporal utility comparisons.<sup>124</sup> An individual can only demonstrate his preference for alternatives available to him at the time he makes his choice.<sup>125</sup> This, along with the fact that an individual’s preference scale changes with time, means that one cannot compare “the ordinal rank an individual places on an alternative at one point in time with the ordinal rank he places on a different alternative at a different point in time.”<sup>126</sup>

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116. ROTHBARD, *supra* note 97, at 23.

117. *Id.* at 2. The concept of demonstrated preference is not to be confused with the revealed-preference approach developed by Professor Paul Samuelson. *See id.* at 5–6 (explaining that the critical difference between revealed preference and demonstrated preference is that the former “assumes the existence of an underlying preference scale that forms the basis of a man’s actions and that remains constant in the course of his actions over time”); *see also* Richard A. Posner, *The Ethical and Political Basis of the Efficiency Norm in Common Law Adjudication*, 8 HOFSTRA L. REV. 487, 489 n.8 (1980) (explaining the revealed-preference approach).

118. ROTHBARD, *supra* note 97, at 2.

119. *Id.*

120. *Id.*

121. *Id.* Consider the hypothetical of a woman shopping for a dress. To simplify things, assume that she is choosing among five dresses, each of which costs forty dollars. Her means (in this case, money) are scarce, and she only has forty dollars to spend. Given her limited means, she will choose the dress that she most prefers. Thus, one can say that her action of purchasing the dress demonstrates her preference for that dress over the four other dresses she could have chosen.

122. *Id.* at 6.

123. *Id.* The woman who purchased the dress could very well change her mind about the desirability of that dress later on. She might return to the store and exchange it for a different dress, thereby demonstrating her preference for the second dress. The concept of demonstrated preference does not require that, once she has demonstrated her preference by buying the first dress, her preference remain constant. That she later changes her mind about the first dress does not mean that the preference, which was revealed by her purchase, was erroneous or inaccurate. Her preference scale has simply changed from time  $t_0$  (the time she bought the first dress) to time  $t_1$  (the time she changed her mind).

124. Herbener, *supra* note 111, at 97.

125. *Id.*

126. *Id.*

In his seminal 1956 paper, *Toward a Reconstruction of Utility and Welfare Economics*,<sup>127</sup> Professor Rothbard used the concept of demonstrated preference to construct an Austrian version of welfare economics.<sup>128</sup> As discussed below, the infeasibility of interpersonal and inter-temporal utility comparisons and the requirement of demonstrated preference place severe constraints on the ability of welfare economics to inform policy decisions.<sup>129</sup> Thus, Austrian welfare economics does not attempt to compare different governmental policies. The central tenet of Austrian welfare economics is simply that voluntary market transactions increase the utility of all participants at the time the transaction takes place because, by entering into the transaction, each party has demonstrated his preference for participating in the transaction over refraining from participation.<sup>130</sup> On the other hand, government interference with market transactions can never increase utility because such interference necessarily involves the use of force to compel one or more participants to accept a less preferred alternative.<sup>131</sup>

## 2. Efficiency Criteria

Since the inception of the law and economics movement, efficiency<sup>132</sup> has been a ground upon which numerous legal arguments have been based.<sup>133</sup> The Pareto-superior and Kaldor-Hicks efficiency criteria originated in utility and welfare economics<sup>134</sup> and are commonly referred to in the law and economics literature.<sup>135</sup> A transaction is Pareto

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127. ROTHBARD, *supra* note 97.

128. See *infra* Part II.D.2 and accompanying text for a discussion of neoclassical welfare economics. To avoid confusion, "Austrian welfare economics" will always be referred to as such; however, neoclassical welfare economics will sometimes be referred to simply as "welfare economics."

129. See *infra* Part III.A and accompanying text for a discussion of the limitations of welfare economics. See also Herbener, *supra* note 111, at 104 ("The impossibility of interpersonal comparisons of utility restricts welfare economics to conclusions about interactions that benefit some without harming any one. . . . The impossibility of inter-temporal comparisons of utility restricts welfare economics to conclusions about interactions at the time they occur.")

130. ROTHBARD, *supra* note 97, at 29 ("Since every exchange demonstrates a unanimity of benefit for both parties concerned, we must conclude that *the free market benefits all its participants.*"); see also Herbener, *supra* note 111, at 104 ("Any voluntary interaction demonstrably benefits each participant at the time it occurs, while doing no demonstrable harm to any non-participant.")

131. ROTHBARD, *supra* note 97, at 30–31; see also Herbener, *supra* note 111, at 106 ("Interventionism consists of the mixture of voluntary and involuntary acts of acquisition and interactions."). See *infra* notes 159–62 and accompanying text for an explanation of why government intervention demonstrably reduces the utility of at least one participant in a transaction.

132. See Roger A. Arnold, *Efficiency vs. Ethics: Which Is the Proper Decision Criterion in Law Cases?*, 4 J. LIBERTARIAN STUD. 49, 49 (1982), for an enumeration of various definitions of efficiency.

133. See, for example, *supra* Part II.C for a discussion of various efficiency arguments for and against the enforcement of penalty clauses.

134. See ROTHBARD, *supra* note 97, at 23–25 (discussing the relationship among welfare economics, the Pareto Unanimity Rule, and the Kaldor-Hicks compensation principle). See generally J.R. Hicks, *The Foundations of Welfare Economics*, 49 ECON. J. 696 (1939).

135. See, e.g., Jules L. Coleman, *Efficiency, Utility, and Wealth Maximization*, 8 HOFSTRA L. REV. 509, 512–14 (1980) (discussing Pareto-superior and Kaldor-Hicks efficiency criteria); Posner, *supra* note 117, at 488–91 (comparing Pareto-superior and Kaldor-Hicks criteria).

superior if it benefits “at least one person while harming no one.”<sup>136</sup> The Kaldor-Hicks efficiency criterion, on the other hand, requires that the gains resulting from a transaction exceed the losses so that the winners could fully compensate the losers and still come out ahead.<sup>137</sup> The Kaldor-Hicks criterion does not, however, require actual compensation to take place; it is sufficient that compensation could potentially take place.<sup>138</sup> Because the Kaldor-Hicks criterion measures efficiency in terms of the potential for monetary compensation, “it solely looks at [a] willingness to pay in dollar terms.”<sup>139</sup>

The Pareto-superior criterion is considered to be an impractical criterion by most law and economics scholars.<sup>140</sup> This is because it is believed that there are no changes in policy that do not make someone worse off.<sup>141</sup> Judge Posner explains that a transaction, such as a sale by A to B of a tomato, could meet the requirement of Pareto superiority if one assumes that no third party is affected by the transaction.<sup>142</sup> However, he argues that the Pareto-superior criterion has little practical value because third-party effects are almost never absent in the real world.<sup>143</sup> Any change in governmental policy, such as moving from a price-controlled market to a free market in tomatoes, or vice versa, necessarily makes someone worse off.<sup>144</sup> Moreover, in the presence of third-party effects, most transactions will fail to satisfy the Pareto-superior criterion.<sup>145</sup> The Kaldor-Hicks criterion, on the other hand, suffers from no such deficiency since it only requires that the winners to any transaction be capable of compensating the losers.<sup>146</sup>

136. Herbener, *supra* note 111, at 85; *see also* Posner, *supra* note 117, at 488 (“Pareto superiority is the principle that one allocation of resources is superior to another if at least one person is better off under the first allocation than under the second and no one is worse off.”).

137. Coleman, *supra* note 135, at 513 (“One state of affairs (*E*) is Kaldor-Hicks efficient to another (*E*) if and only if those whose welfare increases in the move from *E* to *E*' could fully compensate those whose welfare diminishes with a net gain in welfare.”); ROTHBARD, *supra* note 97, at 24–25 (explaining that Kaldor-Hicks criterion only requires that winners “be able to compensate the losers and still remain winners”).

138. *See* Coleman, *supra* note 135, at 513 (indicating that a Kaldor-Hicks efficient transaction is not necessarily Pareto superior because “[t]he failure to require compensation has the effect of making some individuals worse off”).

139. Edward Stringham, *Kaldor-Hicks Efficiency and the Problem of Central Planning*, 4 Q.J. AUSTRIAN ECON. 41, 42 (2001).

140. *See, e.g.*, Posner, *supra* note 117, at 489 (noting that Pareto superiority is an impractical answer to the problem of interpersonal utility comparisons).

141. *See* Guido Calabresi, *The Pointlessness of Pareto: Carrying Coase Further*, 100 YALE L.J. 1211, 1216 (1991) (“[T]he set of Pareto superior changes which would make no one worse off and at least one person better off must ex ante be a void set.”); Posner, *supra* note 117, at 489 (noting that because “classes of transactions” necessarily and often adversely affect third parties and because it would be impossible to obtain the consent of everyone affected, “the Pareto-superiority criterion is useless for most policy questions”).

142. Posner, *supra* note 117, at 489. The reason for this is obvious: in a simple sales transaction between two parties, the only reason that the buyer would purchase the good is if he values the good more than the money he must pay for it, and the only reason that the seller would sell the good is if he values the money he will receive more than he values the good.

143. *Id.* at 489–91.

144. *Id.* at 489.

145. *Id.* at 490. Posner gives the example of a company moving its factory from town A to town B and explains that this move could lower property values in A, thereby making property owners in A worse off. *Id.*

146. *Id.* at 491. In Posner’s factory example, the move would be Kaldor-Hicks efficient if “the decrease in land values in A is matched by the increase in B.” *Id.* Technically, the Kaldor-Hicks criterion requires that

Thus, policy changes and judicial decisions that would fail to satisfy the Pareto-superior criterion could potentially satisfy the Kaldor-Hicks criterion.

*E. Title-Transfer Theory of Contract*

Because of perceived deficiencies in the doctrines of consideration and promissory estoppel, the title-transfer theory of contract has been proposed as an alternative basis for contract enforcement.<sup>147</sup> Under the title-transfer theory, a contract is enforceable only if it constitutes a transfer of title to property from one party to another either at the present or at some future time.<sup>148</sup> Promises are not necessarily enforceable; however, a promise that is “intended and understood to convey title . . . can operate to do so” and would therefore be enforceable.<sup>149</sup> Title transfers are, of course, often conditional, such as a conditional transfer of money to a contractor on the condition that he completes a certain job.<sup>150</sup> Additionally, to account for the uncertainty of the future, “future-oriented title transfers are necessarily conditioned upon the item to be transferred *existing* at the designated time of transfer.”<sup>151</sup> This is because it is impossible to transfer title to something that does not exist.<sup>152</sup>

### III. DISCUSSION

The following Part discusses the deficiencies in the current law of liquidated damages and the theoretical framework used to critique the current law, and offers an alternative to the current law. Section A analyzes the problems with efficiency arguments, as applied to judicial decision-making processes, from an Austrian perspective. Problems with the current law of liquidated damages are considered in Section B, which focuses especially on the unwarranted judicial interference with private transactions necessitated by application of the current law. Section C offers an alternative to the current law, using the title-transfer theory of contracts as the legal framework on which the alternative law is constructed. Section D demonstrates how the alternative law might be applied to real-life situations. In sum, this Comment employs Austrian economic principles to show that judicial scrutiny and non-enforcement of liquidated damages provisions constitute a type of unwarranted paternalistic intervention with market processes and proposes an alternative to the current law, which provides for greater certainty and contractual freedom.

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the gain from a transaction outweigh the loss so that the transaction results in a net gain; but perhaps Posner has assumed that the factory move benefits the factory owner, irrespective of the gains and losses to neighboring landowners.

147. N. Stephan Kinsella, *A Libertarian Theory of Contract: Title Transfer, Binding Promises, and Inalienability*, 17 J. LIBERTARIAN STUD. 11, 11, 21 (2003).

148. *Id.* (“[A] binding contract should be considered as one or more *transfers of title to (alienable) property*, usually title transfers exchanged for each other.”).

149. *Id.* at 22.

150. *See id.* (explaining that future-oriented title transfers may be conditioned “upon certain events taking place”).

151. *Id.* at 23.

152. *Id.* This concept is similar to the common-law defense of impossibility of performance. *See* RESTATEMENT (SECOND) OF CONTRACTS §§ 261, 263 (1981) (stating that impracticability could result in a discharge of the duty to perform).

A. *Defects of Efficiency*

A number of scholars have approached the problem of liquidated damages from an efficiency perspective.<sup>153</sup> The concept of maximizing efficiency has its roots in welfare economics and suffers from the same deficiencies that have plagued welfare economics since its inception.<sup>154</sup>

The insurmountable problem of welfare economics is the impossibility of making interpersonal utility comparisons.<sup>155</sup> Pareto superiority is the only criterion that does not necessitate interpersonal utility comparisons because the requirement that no one be made worse off obviates the need to make such comparisons.<sup>156</sup> Judge Posner's objections to the Pareto-superiority criterion<sup>157</sup> stem from a number of misconceptions regarding demonstrated preference.<sup>158</sup> The Pareto-superior criterion cannot be used to inform policy choices, not because of any inherent deficiency, but because the choice between two governmental policies, such as the choice between a free market in tomatoes and a price-controlled market, requires illegitimate inter-temporal utility comparisons.<sup>159</sup> Imagine, for example, that the status quo involves a market with a price ceiling on tomatoes. Each time a seller is prevented from selling tomatoes at a price he would have sold them absent the price ceiling, his utility is demonstrably reduced.<sup>160</sup> This is because the whole point of imposing a price ceiling is to compel sellers to sell their goods at a lower price than they otherwise would have,<sup>161</sup> thus, "one

153. See *supra* Part II.C for a discussion of various efficiency arguments for and against the enforcement of liquidated damages provisions.

154. See *supra* Part II.D.2 for a discussion of the efficiency criteria.

155. See *supra* notes 105–08, 115, and accompanying text for an explanation of why it is impossible to make interpersonal utility comparisons.

156. See ROTHBARD, *supra* note 97, at 22–23 ("If one individual is worse off, the fact that interpersonal utilities cannot be added or subtracted prevents economics from saying anything about social utility.").

157. See *supra* notes 142–45 and accompanying text for a discussion of Posner's objections to the Pareto-superior criterion.

158. These misconceptions are by no means unique to Posner. Posner's example of choosing between a free market in tomatoes and a price-controlled market is reminiscent of the repeal of Corn Laws in nineteenth-century England discussed in Nicholas Kaldor, *Welfare Propositions of Economics and Interpersonal Comparisons of Utility*, 49 *ECON. J.* 549, 549–50 (1939). The repeal of Corn Laws harmed some while benefiting others and would therefore not satisfy the Pareto-superior criterion. Kaldor proposed his compensation principle in response to this problem, commenting that:

There is no need for the economist to prove—as indeed he never could prove—that as a result of the adoption of a certain measure nobody in the community is going to suffer. . . . [I]t is quite sufficient for him to show that even if all those who suffer as a result are fully compensated for their loss, the rest of the community will still be better off than before.

*Id.* at 550.

The idea that market activity (such as the relocation of a factory) can inflict losses on third parties is also not original to Posner. J.R. Hicks addressed a similar concept in Hicks, *supra* note 134, at 709–10, where he discussed the losses inflicted on third parties by the closing of a firm.

159. Herbener, *supra* note 111, at 96–97.

160. See *id.* at 96 ("Each time the duty was levied on exporters of grain, they had their utility demonstrably reduced."). The predicament of grain exporters who are compelled to pay a tax is analogous to that of tomato sellers who are compelled to sell tomatoes at a lower price than that which they would have otherwise selected.

161. Of course, it is possible to imagine a situation where the price ceiling is much higher than the market price so that no seller would have exceeded (and no buyer in his right mind would have bought at) that

can *infer* that such an involuntary social interaction, unlike a voluntary one, forces him to accept a less-preferable alternative.”<sup>162</sup>

Now imagine that the price-control law is repealed. Because an individual can only demonstrate his preference for alternatives that are actually available to him at the time of action, a buyer of tomatoes cannot demonstrate his preference for the old, lower price because that price is no longer a social option.<sup>163</sup> Thus, any statement regarding the buyer’s utility before and after the move from a price-controlled to a free market in tomatoes involves an illegitimate inter-temporal utility comparison. Thus, we see that the Pareto-superior criterion is indeed unhelpful in informing choices between alternative policies. However, this is not a result of some deficiency that is unique to the Pareto-superior criterion; rather, it is a result of the infeasibility of making inter-temporal utility comparisons.

Posner’s second objection to the Pareto-superior criterion, that third-party effects will render almost all transactions Pareto-inferior, can be dispelled through a rigorous application of the concept of demonstrated preference.<sup>164</sup> In Posner’s hypothetical, a factory moves from town A to town B, causing a reduction in property values in A, thereby making property owners in A worse off.<sup>165</sup> This third-party effect allegedly renders the move Pareto-inferior.<sup>166</sup> However, this assumption is incorrect. Because the landowners in A are not parties to the transaction, they are unable to demonstrate their preference through action. For this reason, one cannot say anything about their preferences or whether they were made worse or better off by the move.<sup>167</sup>

The Kaldor-Hicks efficiency criterion supposedly transcends the limitations of the Pareto-superior criterion.<sup>168</sup> As discussed above, however, the infeasibility of inter-temporal utility comparisons is not a limitation that is unique to the Pareto-superior criterion; it is a limitation imposed by the fact that preferences can only be revealed through action and that only preferences for currently available alternatives can be meaningfully demonstrated. Thus, the infeasibility of inter-temporal utility comparisons likewise prevents the Kaldor-Hicks criterion from meaningfully informing policy decisions. Even if one was to use willingness to pay, rather than utility, as a

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price even without the ceiling. In that situation, the price ceiling would have no practical effect, but that is not the kind of situation present in this context.

162. Herbener, *supra* note 111, at 103. Professor Herbener goes on to explain that “[i]t is by this inference, and not his action under duress . . . that the Pareto-Inferior nature of involuntary interactions is seen.” *Id.* at 103–04. In other words, because the tomato seller probably would not have sold tomatoes below the market price in the absence of a price ceiling, one can infer that the price ceiling has compelled the seller to accept a less preferred alternative even though he is unable to demonstrate his preference for the prohibited alternative through his actions.

163. See Herbener, *supra* note 111, at 97 (“The genuine alternatives are only those being offered given the new social situation, the old (status quo) situation is now irrelevant.”).

164. See *supra* note 145 and accompanying text for a discussion of how transactions can negatively impact third parties.

165. See *supra* note 145 for a discussion of the factory hypothetical.

166. See Posner, *supra* note 117, at 490.

167. See ROTHBARD, *supra* note 97, at 29 (stating that preferences not demonstrated through action are irrelevant).

168. See *supra* note 145–46 and accompanying text for a comparison between the Kaldor-Hicks and Pareto-superior criteria.

measure of efficiency, the same problem would result. This is because willingness to pay is only a reflection of one's underlying preference scale, which changes with time.<sup>169</sup> Thus, there is no reason to assume that an individual's willingness to pay for an outcome at one point in time would be the same as his willingness to pay for that same outcome at a different point in time.<sup>170</sup> Moreover, given the restriction of demonstrated preference,<sup>171</sup> willingness to pay in the abstract is a meaningless concept. Until the payment is actually made, one cannot make any statement about a person's willingness to pay.<sup>172</sup>

The use of indifference curve analysis, borrowed from neoclassical welfare economics, to justify the application of certain legal rules, such as the enforcement of penalty clauses,<sup>173</sup> is problematic because indifference curve analysis is based on the erroneous assumption of cardinal utility and presupposes the practicability of making interpersonal utility comparisons.<sup>174</sup> Moreover, the use of continuous mathematical functions is inappropriate for the analysis of human action because of the imperceptibility of infinitesimal changes.<sup>175</sup>

Thus, we see that the use of efficiency criteria and other tools borrowed from neoclassical welfare economics to justify the choice of legal rules and inform judicial decisions is problematic from an economic standpoint.<sup>176</sup> Exclusive reliance on efficiency and utilitarian arguments, however, is also inappropriate from a jurisprudential standpoint. The proper function of the judiciary is, after all, the administration of justice and the adjudication of rights, not the maximization of wealth or efficiency.<sup>177</sup>

#### B. *Problems with the Current Law*

Perceived problems with the current law have led a number of scholars to propose more enforcement-friendly alternatives.<sup>178</sup> This Section discusses the deficiencies of

169. See *supra* notes 122–23 and accompanying text for a discussion of the inconstancy of an individual's preference scale over time.

170. See Stringham, *supra* note 139, at 42–43 (explaining that “valuations change according to market conditions” and that “[e]ven if exogenous variables were fairly constant, there is no reason [to expect] to see stable preferences over time”).

171. See *supra* notes 117–21 and accompanying text for a discussion of demonstrated preference.

172. See ROTHBARD, *supra* note 97, at 6–7 (“Not only will a person's valuation[s] differ when talking about them from when he is actually choosing, but there is also no guarantee that he is telling the truth.”).

173. See, e.g., Goetz & Scott, *supra* note 19, at 566–68 (using an indifference curve analysis to explain how enforcement of penalty clauses can yield efficient results); see also Birmingham, *supra* note 110, at 63–68 (analyzing contract damages through the use of indifference curves and utility frontiers).

174. See *supra* notes 109–11 and accompanying text for an explanation of the illegitimacy of indifference curve analysis.

175. See *supra* notes 112–14 and accompanying text for a discussion of the problems associated with the use of continuous functions in the study of human action.

176. The ethical implications of basing judicial decisions on efficiency grounds are beyond the scope of this Comment. For a discussion of these ethical implications, see generally Walter Block, *Coase and Demsetz on Private Property Rights*, 1 J. LIBERTARIAN STUD. 111, 111 (1977).

177. Cf. Arnold, *supra* note 132, at 51–52 (arguing that ethics, rather than efficiency, is the more appropriate criterion for legal decision making).

178. See *supra* Part II.C.1–2 for examples of proposed alternatives to the current law.

the current legal framework, focusing especially on the judicial intervention that attends enforcement of the current law and attempting to demonstrate, through application of Austrian welfare economics, that such intervention is unwarranted and unjustifiable.

The current rule, which predicates enforcement on a determination of the reasonableness of the stipulated amount and the difficulty of ascertaining actual damages, is problematic in a number of ways. First, it adds an extra layer of uncertainty to market transactions by inviting the breaching party to challenge the enforceability of liquidated damages provisions in court. Under the current rule, parties cannot know with certainty *ex ante* whether a bargained-for liquidated damages provision will be enforced.

Second, the current rule prevents individuals from recovering damages for purely subjective losses that cannot be objectively assessed by reference to external market prices. Purely subjective losses are usually incurred when the promisee attaches some kind of sentimental value, or what Goetz and Scott call idiosyncratic value, to performance.<sup>179</sup> These losses are not recoverable under the just compensation principle because they are not capable of determination with reasonable certainty and are often unforeseeable.<sup>180</sup> Like damages for emotional disturbance, purely subjective damages are difficult to prove and impossible to measure post-breach.<sup>181</sup> Since they result from a loss of subjective or sentimental value, they exist only in the mind of the promisee. Absent a mind-reading device, there can be no direct evidence of the existence of such damages. Circumstantial evidence that the promisee attaches special sentimental value to a promised performance may be available, such as in situations where sentimental value can be inferred through past actions or statements by the promisee. However, even if the existence of subjective damages may be proven by circumstantial evidence, they would be completely incapable of measurement or assessment by a court *ex post*. As discussed earlier, the value an individual attaches to any given end is purely subjective and incapable of measurement.<sup>182</sup> Thus, subjective losses cannot be measured or even estimated by a court post-breach.<sup>183</sup> Additionally, if the promisee's attachment of particular sentimental value to performance was unknown to the promisor before breach, these subjective damages would likely also have been

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179. See Goetz & Scott, *supra* note 19, at 570. See also *supra* notes 61–64 and accompanying text for a discussion of idiosyncratic value.

180. See *supra* notes 10–12 and accompanying text for a discussion of the just compensation principle's preclusion of recovery of uncertain or unforeseeable damages. See *Carpel v. Saget Studios, Inc.*, 326 F. Supp. 1331, 1333–34 (E.D. Pa. 1971) (concluding that loss of sentimental value is too speculative to be considered in the calculation of contract damages).

181. See *supra* notes 11, 13–14, and accompanying text for a discussion of damages for emotional disturbance. In fact, damages caused by emotional disturbance may be considered a specific type of purely subjective loss.

182. See *supra* notes 105–08 and accompanying text for a discussion of the immeasurability of an individual's subjective valuations.

183. Courts obviously cannot resort to asking the promisee to assess his own damages post-breach because there would be no way to prevent the promisee from exaggerating his losses in order to recover more than he deserves.

unforeseeable by the promisor, in which case award of such damages would violate the promisor's reasonable expectations.<sup>184</sup>

Liquidated damages provisions provide a means for contracting parties, to whom performance carries unique subjective value, to protect their interests.<sup>185</sup> However, if the stipulated sum in a liquidated damages provision reflects the promisee's subjective or idiosyncratic value, it will likely exceed the objective measure of "actual damages," whether such damages are assessed *ex ante* or *ex post*. Thus, under the current rule, such liquidated damages provisions are likely to be deemed unenforceable.

Third, the current rule requires courts to intervene in the transactions of private parties for no justifiable reason.<sup>186</sup> Under Austrian welfare economics, voluntary market transactions demonstrably benefit both parties at the time the transaction takes place.<sup>187</sup> Thus, when two parties voluntarily enter into a contract, they do so only because, at the time of contract formation, they perceive the terms, including the terms of any liquidated damages provision, to be favorable to them. In other words, their action of entering into the contract demonstrates that they prefer engaging in that transaction over any other alternative available to them at that time, such as not entering into the contract or renegotiating the terms. Because both parties prefer entering into the contract over any other then-available alternative, the contractual relationship increases each party's utility at the time the relationship is consummated.<sup>188</sup>

After the contract is executed, market conditions might change, and the terms of the contract may no longer appear favorable to one of the parties. This does not mean, however, that the contract was not mutually beneficial at the time it was made. Here, as in the previously discussed hypothetical of moving from a price-controlled market to a free market in tomatoes, the principle of demonstrated preference and concomitant infeasibility of making inter-temporal utility comparisons prevents us from making any statement about the *ex post* utility of any party to the contract.<sup>189</sup> In other words, one cannot say that because market conditions have changed, one party's *ex post* utility is

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184. See *supra* note 12 and accompanying text for a statement of the rationale behind the foreseeability limitation.

185. See *infra* Part III.D for a discussion of how inclusion of a liquidated damages provision allows a promisee to protect his unique interests.

186. The fact that courts routinely enforce liability limitation provisions without first subjecting such provisions to judicial scrutiny and reasonableness tests further demonstrates the irrationality of the current law. See *supra* Part II.B.1.c for a discussion of liability limitation provisions. Liability limitation provisions are essentially underliquidated damages provisions that can appear unjust to the promisee to the same extent that overliquidated damages provisions can appear unjust to the promisor *ex post*. Thus, there is no justifiable reason to treat these two types of provisions differently, except for the common law's arcane aversion to penalty clauses.

187. See *supra* note 130 and accompanying text for an explanation of the reason why voluntary market transactions benefit both parties at the time of the transaction.

188. See, e.g., Herbener, *supra* note 111, at 100 (stating that when a person enters into an employment contract, both he and his employer benefit at the time the contract is made).

189. See Herbener, *supra* note 111, at 102 ("[A]cceptance of the principle of demonstrated preference logically requires restrictions on statements about utility to those referring to points in time when action is taken. To make an *ex post* statement about utility requires an impermissible inter-temporal utility comparison.").

less than his utility *ex ante*; any such statement requires an illegitimate inter-temporal utility comparison.<sup>190</sup>

Assume that *A* and *B* enter into a contract whereby *A* promises to sell *B* thirty tons of coal for \$30,000. *A*'s and *B*'s actions of making the contract tell us that the transaction benefits both of them at the time the contract is made. The fact that the contract locks in the price of coal at \$1,000 per ton also reflects an allocation of risk between *A* and *B*.<sup>191</sup> By agreeing to this locked-in price, *A* bears the risk that the market price of coal will decrease in the future (i.e., at or around the time delivery is to be made), and *B* bears the risk that the future market price of coal will be higher than expected. Now, suppose that after the contract is executed, the price of coal increases to \$1,100 per ton so that it would no longer be profitable for *B* to render performance. At this point, *B* can either breach the contract and pay damages (the measure of which will be determined by a court post-breach), or he can render performance. Either alternative results in a loss to *B*. In this situation, *B*'s loss is entirely a result of his lack of entrepreneurial<sup>192</sup> foresight (i.e., his erroneous prediction of future coal prices).<sup>193</sup> The fact that he sustained a loss does not alter the fact that he benefited from the contract at the time the contract was made.<sup>194</sup>

Now consider the same hypothetical with the additional fact that *A* wants to ensure *B*'s performance of the contract, so he insists on the inclusion of a provision providing for damages of \$500 per ton of coal that *B* fails to deliver. *B* negotiates a \$5,000 increase in the contract price in exchange for inclusion of this penalty provision. *A*'s agreement to pay an extra \$5,000 for the inclusion of the penalty clause tells us that he prefers the penalty provision to the \$5,000 he could have saved by forgoing the

190. *See id.* at 102 n.70 (explaining that even where an entrepreneur sustains a loss as result of action, one cannot say that his *ex post* utility is less than his *ex ante* utility because "[s]uch a statement presupposes the ability to make inter-temporal utility comparisons").

191. Technically, the problem that *A* and *B* face in this situation is uncertainty, not risk. As Professor Rothbard explains, "[e]stimates of future costs, demands, etc., on the part of entrepreneurs are all unique cases of uncertainty, where methods of specific understanding and individual judgment of the situation must apply, rather than objectively measurable or insurable 'risk.'" ROTHBARD, *supra* note 90, at 555.

192. An entrepreneur is someone who acts in the face of uncertainty and takes advantage of ever-changing market conditions by attempting to profit from correct predictions of future market trends, such as consumer demand. *See MISES, supra* note 93, at 254–55 ("Entrepreneur means acting man in regard to the changes occurring in the data of the market.").

193. An entrepreneur sustains a loss when he inaccurately predicts future market prices. Professor Rothbard explains:

A *loss* occurs when an entrepreneur has made a poor estimate of his future selling prices and revenues. He bought factors, say, for 1,000 ounces, developed them into a product, and then sold it for 900 ounces. . . .

Every entrepreneur, therefore, invests in a process because he expects to make a profit, i.e., because he believes that the market has underpriced and undercapitalized the factors in relation to their future rents. If his belief is justified, he makes a profit. If his belief is unjustified, and the market, for example, has really overpriced the factors, he will suffer losses.

ROTHBARD, *supra* note 90, at 512; *see also* Herbener, *supra* note 111, at 102 ("The extent of profit or loss is determined by his entrepreneurial insight, that is, how accurately he anticipated the outcome of the sequence of actions.").

194. *See* Herbener, *supra* note 111, at 102 (explaining that whether an individual makes a profit or incurs a loss from a voluntary market activity does not affect the "fact that he acquires, without exception, subjective benefit in each of his voluntary exchanges").

provision. By the same token, *B*'s agreement to include the penalty clause for an extra \$5,000 tells us that *B* prefers the \$5,000 over the reduced liability of not having a penalty clause. After the contract is executed, the market price of coal again rises to \$1,100. *B* is now faced with a choice between rendering performance and absorbing the loss of \$100 per ton (plus any costs associated with acquiring and delivering the coal to *A*) or breaching the contract and paying \$500 per ton in damages.<sup>195</sup> Here, as in the hypothetical without a penalty clause, any loss sustained by *B* is the result of his lack of entrepreneurial insight. The only difference is that in the current hypothetical, *B* has made two entrepreneurial errors instead of one. His first error is entering into a contract that locked in the price of coal at \$1,000 per ton, and his second error is agreeing to the inclusion of a penalty clause. The loss *B* sustains *ex post* does not alter the fact that the contract was mutually beneficial *ex ante*.

If *B* chooses to render performance, one can say that *B* prefers that option to any other alternative available to him at that time; conversely, if *B* chooses to breach the contract, one can say that *B* prefers breach to any other then-available alternative. Thus, if *B* breaches the contract and a court enforces the penalty clause, one cannot say that *B*'s utility is thereby reduced. This is because once *B* entered into the contract that included a penalty clause, other alternatives—not entering into the contract or entering into a contract with different terms—are no longer available to him. Thus, he can no longer demonstrate his preference for those alternatives. For this reason, any statement about *B*'s *ex post* utility would involve an impermissible inter-temporal utility comparison.<sup>196</sup>

Additionally, because interpersonal comparisons of utility cannot be made,<sup>197</sup> one cannot make any statement about aggregate or social utility.<sup>198</sup> Hence, one cannot say that enforcement of the penalty clause will result in a reduction of social utility.<sup>199</sup>

In fact, if the court refuses to enforce the contract, *A*'s utility would be demonstrably reduced.<sup>200</sup> Through *A*'s action, we know that *A* preferred having the penalty clause over any other alternative available to him at the time the contract was made. By refusing to enforce the contract, the court would force *A* to accept a less preferred alternative.

Because any loss sustained by *B* is entirely a result of his lack of entrepreneurial foresight, there is no reason for the court to intervene and rescue *B* from the consequence of his own improvidence. This is especially true when judicial

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195. *B* could also attempt to renegotiate with *A*; however, that option is only viable if *A* agrees to a renegotiation.

196. See *supra* notes 124–26 and accompanying text for a discussion of the impermissibility of inter-temporal utility comparisons.

197. See *supra* note 115 for an explanation of why interpersonal utility comparisons cannot be made.

198. See *supra* notes 115–16 and accompanying text for a discussion of social utility.

199. This result follows logically from the earlier discussion. If any statement regarding *B*'s *ex post* utility is illegitimate, then any statement about *ex post* social utility is doubly illegitimate because it presupposes both interpersonal and inter-temporal utility comparisons. First, because of the immeasurability of individual utility and the infeasibility of interpersonal utility comparisons, the utility of individuals cannot be summed up to yield an aggregate or social utility. Second, because of the infeasibility of inter-temporal utility comparisons, one cannot compare utility *ex post* with that *ex ante*.

200. See *supra* notes 159–62 and accompanying text for an explanation of how government intervention demonstrably reduces the utility of at least some individuals.

intervention cannot be had but at the expense of another party whose utility would be demonstrably reduced by the court's intervention.

C. *A Rights-Based Approach to Enforcement*

The problems with the current law could be remedied with a rule that favors enforcement of liquidated damages provisions regardless of reasonableness. Such a rule would provide certainty to the parties, enforce party expectations, allow for the recovery of subjective damages, and obviate the need for judicial interference. The following Section attempts to explain the theoretical justification for an all-enforcement rule under the title-transfer theory of contracts.

The enforcement of liquidated damages clauses, regardless of the reasonableness of the stipulated sum or whether the parties intended for the clause to be an estimate of actual damages or a penalty to compel performance, is easily justified under the title-transfer theory of contracts.<sup>201</sup> Under the title-transfer theory, a contract whereby one party promises to render performance in exchange for payment is enforceable because the promisor essentially agrees to a transfer of title to an amount of money, conditioned upon the promisor's breach.<sup>202</sup> The exact amount to be transferred in the event of breach can be determined *ex ante* in the form of a liquidated damages, or even penalty provision, or determined postbreach by a court or arbitrator. Thus, under the title-transfer theory, where a contract contains a liquidated damages (or penalty) provision, as soon as the condition precedent (i.e., breach) occurs, title to the stipulated amount automatically transfers to the promisee.<sup>203</sup> Enforcement of the clause amounts to nothing more than protection of the promisee's property rights.

In the coal sales hypothetical above, *B*'s execution of the contract effectuated a conditional transfer of title to the \$15,000 in damages, the occurrence of which is conditioned upon *B*'s failure to perform. As soon as the condition is met (i.e., as soon as *B* breaches) title to the money vests in *A*.<sup>204</sup> Thus, refusal to enforce the penalty clause amounts to a deprivation of *A*'s property rights.

D. *Application*

As mentioned previously, the enforcement of liquidated damages provisions provides contracting parties with a means to protect unique interests, such as the subjective or sentimental value a party attaches to performance.<sup>205</sup> This Section discusses the application of an enforcement rule for liquidated damages provisions in light of common problems that such a rule might be capable of resolving.

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201. See *supra* Part II.E for a discussion of the title-transfer theory of contracts.

202. Kinsella, *supra* note 147, at 25.

203. This mechanism of transfer would be similar to a possibility of reverter, where interest in the property automatically vests in the grantor as soon as the condition that triggers termination of the estate occurs. See generally 28 AM. JUR. 2D *Estates* § 189 (2010) (discussing possibilities of reverter).

204. See *supra* note 202 and accompanying text for a discussion of this automatic transfer of title.

205. See *supra* notes 182–88 and accompanying text for a discussion of how damages resulting from loss of sentimental or idiosyncratic value are unrecoverable under the just compensation principle and unlikely to be recoverable under the current law of liquidated damages.

### 1. Sentimental Value

In *Carpel v. Saget Studios, Inc.*,<sup>206</sup> plaintiffs brought suit against defendant for failure to deliver photographs of their wedding.<sup>207</sup> Plaintiffs attempted to recover lost sentimental value due to defendant's breach.<sup>208</sup> The court, however, held that loss of sentimental value is too speculative to be "a proper element of damages for consideration by the jury" because "[t]here are no guidelines available to aid the jury in determining a dollar value for this loss."<sup>209</sup>

Whereas purely subjective losses, such as loss of sentimental value, are difficult to prove and impossible to measure postbreach, problems of proof and measurement do not arise when anticipated subjective losses are accounted for ex ante in a liquidated damages or penalty provision. When a party negotiates a liquidated damages provision that accounts for subjective losses that the party expects to result from the other party's breach ex ante, there can be no question as to the existence of such losses ex post.<sup>210</sup> The existence of a liquidated damages provision also obviates the need for ascertainment of the measure of damages postbreach.

There is also no danger that the promisee would exaggerate the extent of his anticipated subjective loss during negotiations because the promisor would likely demand an increase in the contract price in exchange for assenting to the inclusion of a liquidated damages provision, and one would expect the premium associated with the clause to be proportional to the size of the stipulated sum. Thus, the cost associated with the clause ensures that the stipulated amount will be an accurate reflection of the subjective loss the promisee expects to sustain as a result of the promisor's breach. In other words, the subjective value of performance to the promisee is reflected in the price that he is willing to pay for inclusion of the clause.

### 2. Economic Waste

In *Peevyhouse v. Garland Coal & Mining Co.*,<sup>211</sup> a case that will no doubt continue to shock the conscience of first-year law students for decades to come, the Oklahoma Supreme Court applied the doctrine of economic waste<sup>212</sup> to determine the measure of damages due plaintiffs as a result of defendant mining company's nonperformance of several provisions of a lease agreement.<sup>213</sup> Plaintiffs leased their farm to defendant so that defendant could mine coal from the deposits on the farm.<sup>214</sup>

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206. 326 F. Supp. 1331 (E.D. Pa. 1971).

207. *Carpel*, 326 F. Supp. at 1331.

208. *Id.* at 1332.

209. *Id.* at 1333.

210. In other words, the liquidated damages provision is itself evidence of the existence of subjective losses.

211. 382 P.2d 109 (Okla. 1962).

212. See 13 AM. JUR. 2D *Building and Construction Contracts* § 82 (2010) ("The 'economic waste' doctrine in general means that the cost of completion as required by the contract greatly outweighs the benefit to the owner to do so . . . . When repairing or reconstructing a structure would constitute unreasonable economic waste, the measure of an owner's damages for the contractor's breach of contract is the difference in value between the structure as built and the structure as contracted for.")

213. *Peevyhouse*, 382 P.2d at 113–14.

214. *Id.* at 111.

The lease explicitly provided for the completion of “certain restorative and remedial work” by defendant.<sup>215</sup> The court found that the restoration would cost approximately \$29,000<sup>216</sup> but would only increase the market value of the property by \$300.<sup>217</sup> Applying the doctrine of economic waste, the court held that, where the cost of performance is grossly disproportionate to the economic benefit that plaintiffs would receive from full performance, the measure of damages is the diminution in property value caused by nonperformance rather than the cost of performance.<sup>218</sup> The court then reduced the plaintiffs’ damage award to \$300.<sup>219</sup>

The *Peevyhouse* court’s categorical refusal to enforce the explicit terms of a valid contract is especially shocking in view of the fact that the plaintiffs specifically negotiated for the restoration provisions and would not have entered into the agreement had those provisions not been included.<sup>220</sup> Despite the fact that the court’s decision appears to be overtly inconsistent with the basic principle of freedom of contract, and is also erroneous in view of the principles of Austrian economics,<sup>221</sup> assume for a moment that the doctrine of economic waste should be a legitimate default rule. How may parties in the *Peevyhouses*’ position protect themselves from such a rule? Under the current law of liquidated damages, the only viable means available to them is perhaps to raise the contract price to cover for the cost of restoration. This, of course, assumes that the cost of restoration can be estimated *ex ante*.<sup>222</sup> If the cost cannot be reasonably estimated *ex ante*, then plaintiffs would have no way to protect their interests under the current law. Even if plaintiffs negotiate for the inclusion of a liquidated damages provision, explicitly providing that the measure of damages for failure to perform restoration will be the cost of performance, such a provision will almost certainly be held unenforceable. This is because the stipulated amount in this

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215. *Id.*

216. *Id.*

217. *Id.* at 114. The court, reasoning that if plaintiffs were awarded the cost of performance, they “might recover an amount about nine times the total value of their farm,” concluded that such a result would be “unconscionable and grossly oppressive.” *Id.* at 113. How it is that enforcement of explicitly bargained-for contract terms, negotiated and voluntarily assented to by a sophisticated commercial party, could possibly be unconscionable and grossly oppressive was not explained.

218. *Id.* It is interesting that the court analogized its decision to cases in which courts refused to enforce liquidated damages provisions “in spite of the agreement of the parties.” *Id.* at 113 (emphasis omitted).

219. *Id.* at 114. The jury had awarded plaintiffs \$5,000 in damages. *Id.* at 111.

220. *Id.* at 115 (Irwin, J., dissenting).

221. This is a situation where a court, through the exercise of judicial fiat, substituted the market value of the property for the plaintiffs’ subjective valuation of performance. There is no economic justification for such a substitution since value is wholly subjective. Indeed, by their action of bargaining for the inclusion of the restoration provisions, plaintiffs demonstrated their preference for having their property restored. There is no other evidence of their subjective valuation (except, perhaps, by bringing an action to enforce the contract, they again demonstrated their preference for restoration of their property). Thus, there is no justifiable ground for the court to disregard the plaintiffs’ demonstrated preference and replace their subjective valuation with market value. Moreover, the court’s refusal to enforce the contract demonstrably reduced the plaintiffs’ utility since it effectively forced them to accept a less preferable alternative (i.e., \$300 instead of having their property restored).

222. The dissent in *Peevyhouse* placed great emphasis on the fact that the cost of performance could have been estimated during negotiations because it indicates that defendant knew what it was agreeing to when it executed the contract. *Peevyhouse*, 382 P.2d at 115 (Irwin, J., dissenting). However, the cost of performance might not be capable of estimation *ex ante* in every situation.

case (the cost of performance) would be grossly disproportionate to actual damages if the court employs the diminution in property value as the measure of actual damages. Thus, only by modifying the current rule of conditional enforcement into an all-enforcement rule will contracting parties be provided with a means of protecting their interests in the face of default rules that can be hostile to contract enforcement.

### 3. Prevention of Abuse

The defense of impossibility<sup>223</sup> and the implied covenant of good faith and fair dealing<sup>224</sup> protect the promisor from undue hardship and/or bad-faith breach-inducing practices by the promisee.<sup>225</sup> In addition, the promisor can bargain for the inclusion of a force majeure clause that would excuse nonperformance or delays in performance caused by events beyond his control.<sup>226</sup>

For example, in *Madsen v. Anderson*,<sup>227</sup> a case involving a real estate contract containing a forfeiture clause, the court refused to find forfeiture because the sellers' action "was somewhat misleading."<sup>228</sup> The clause provided for the forfeiture of the buyers' purchase payments as liquidated damages and the discharge of the sellers' obligation to convey the property in the event that the buyers violated the terms of the contract.<sup>229</sup> Pursuant to the contract, the buyers agreed to pay property taxes; however, the tax assessment notices continued to be mailed to the sellers' address.<sup>230</sup> When the sellers demanded reimbursement from the buyers, the buyers asked for receipts of the tax payments.<sup>231</sup> The sellers were not entirely cooperative with the buyers' request, forwarding proof of only part of the taxes paid on the property.<sup>232</sup> The buyers asked for better evidence, but none was provided.<sup>233</sup> The sellers subsequently declared forfeiture.<sup>234</sup> The court reasoned that it was not unreasonable for the buyers to request

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223. See RESTATEMENT (SECOND) OF CONTRACTS § 261 (1981) ("Where, after a contract is made, a party's performance is made impracticable without his fault by the occurrence of an event the non-occurrence of which was a basic assumption on which the contract was made, his duty to render that performance is discharged, unless the language or the circumstances indicate the contrary." (minor typographical errors corrected)).

224. See *id.* § 205 ("Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement.").

225. See *supra* Part II.C.3 for a discussion of some commentators' concern that an all-enforcement rule would encourage bad-faith breach-inducing behavior on the part of the promisee.

226. See, e.g., *Hutton Contracting Co. v. City of Coffeyville*, 487 F.3d 772, 778 (10th Cir. 2007) (evaluating a force majeure clause providing for an extension of time for completion caused by events beyond contractor's control, "including Acts of God, fires, floods, and acts or omissions of the [City] with respect to matters for which the [City] is solely responsible" (alterations in original)); *Seaboard Lumber Co. v. United States*, 308 F.3d 1283, 1292 (Fed. Cir. 2002) (evaluating a force majeure clause providing for an adjustment of contract terms in case of delays "due to causes beyond Purchaser's control, including but not limited to acts of God, acts of the public enemy, acts of Government, labor disputes, fires, insurrections or floods").

227. 667 P.2d 44 (Utah 1983).

228. *Madsen*, 667 P.2d at 48.

229. *Id.* at 45.

230. *Id.*

231. *Id.* at 46.

232. *Id.*

233. *Id.*

234. *Id.*

proof of the sellers' tax payments and that the contract "must be read in light of the [implied covenant] that the parties will deal fairly, extend reasonable cooperation, and act in good faith."<sup>235</sup> In addition, the court found that the sellers' inclusion of partial proof of tax payments in their second letter could have misled the buyers into believing that reimbursement would not be due until proof of all the tax payments were received.<sup>236</sup>

The conduct of the sellers in *Madsen*, though not fully cooperative, was hardly egregious. The court nonetheless declined to find forfeiture because the sellers' conduct was inconsistent with the spirit of the covenant of good faith and fair dealing.<sup>237</sup> Parties seeking to enforce liquidated damages clauses should be held to the same standard of good faith and reasonable cooperativeness as that applied in *Madsen* in order to prevent the sort of bad faith or breach-inducing behavior discussed by Clarkson, Miller, and Muris.<sup>238</sup>

Reputation effects are another source of deterrence from bad-faith breach-inducing practices.<sup>239</sup> Even if a commercial party were able to engage in breach inducement without being detected by the court, such bad-faith behavior will likely so damage that party's reputation that it would be significantly more difficult for it to obtain similar contract terms in the future.

#### IV. CONCLUSION

By requiring courts to scrutinize liquidated damages provisions for reasonableness before enforcing such provisions, the current law of liquidated damages compels courts to interfere with the private transactions of contracting parties.<sup>240</sup> Such judicial intervention is unnecessary because a voluntarily entered into contract demonstrably benefits both parties to the contract at the time of contract formation. If market conditions change after contract formation, thereby rendering the contract terms unfavorable to one of the parties, any losses sustained by such a party is entirely due to his own lack of entrepreneurial foresight. Entrepreneurial profits and losses are a normal part of a market economy, and the fact that the losing party might sustain greater losses as a result of the liquidated damages provision does not mean that the court must therefore intervene to rescue him from his own entrepreneurial error.

An alternative legal rule, favoring the enforcement of liquidated damages provisions regardless of reasonableness, can be premised upon the title-transfer theory of contracts.<sup>241</sup> Under the title-transfer theory, when a promisor agrees to a contract containing a liquidated damages provision, he has essentially agreed to transfer title to

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235. *Id.* at 48.

236. *Id.*

237. *Id.*

238. See *supra* Part II.C.3 for a discussion of the potential problem of breach inducement discussed by Clarkson, Miller, and Muris, *supra* note 60, at 368.

239. See Timothy J. Muris, *Opportunistic Behavior and the Law of Contracts*, 65 MINN. L. REV. 521, 527 (1981) (noting that the "risk of a bad reputation may deter some acts of opportunism"; however, such deterrence may fail under some circumstances).

240. See *supra* Part III.B for a discussion of the problems with the current law of liquidated damages.

241. See *supra* Part II.E for a discussion of the title-transfer theory of contracts.

the amount of money damages specified in the provision to the promisee, conditioned upon the occurrence of breach. Once breach occurs, title to the sum of money transfers automatically to the promisee, and protection of the promisee's property rights necessitates enforcement of the provision.<sup>242</sup>

This alternative legal rule overcomes many of the shortcomings of the current law of liquidated damages. It enables contracting parties to protect the purely subjective value they attach to performance and creates greater certainty that contracts will be enforced.<sup>243</sup>

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242. See *supra* Part III.C for an explanation of this property rights-based approach to the enforcement of liquidated damages provisions.

243. See *supra* Part III.D for a discussion of how this alternative rule could be applied to remedy some of the problems caused by the current rule of liquidated damages.

