Comparative Law Review

Rescuing Comparative Law and Economics?
Exploring Successes and Failures of an Interdisciplinary Experiment

COMPARATIVE LAW REVIEW
The Comparative Law Review is a biannual journal published by the
I. A. C. L. under the auspices and the hosting of the University of Perugia Department of Law.

Office address and contact details:
Department of Law - University of Perugia
Via Pascoli, 33 - 06123 Perugia (PG) - Telephone 075.5852437
Email: complawreview@gmail.com

Comparative Law Review is registered at the Courthouse of Monza (Italy) - Nr. 1988 - May, 10th 2010.

COMPARATIVE
LAW
REVIEW
SPECIAL ISSUE – VOL. 12 /2

Edited by Giuseppe Bellantuono

Rescuing Comparative Law and Economics?
Exploring Successes and Failures of an Interdisciplinary Experiment

COMPARATIVE
LAW
REVIEW
SPECIAL ISSUE – VOL. 13/1

Edited by Giuseppe Bellantuono

Rescuing Comparative Law and Economics?
Exploring Successes and Failures of an Interdisciplinary Experiment

THE LAW OF PENALTY CLAUSES: 'NEW' COMPARATIVE AND ECONOMIC REMARKS

Giuseppe Versaci

TABLE OF CONTENTS

Comparative legal scholarship has often focused on penalty clauses, in particular highlighting the macro-differences between civil law and common law. In 1995, an author also compared the efficient model on forfeited damage clauses with the real-world alternatives of different legal systems. At that time, it was possible on a general and abstract basis under the influence of mainstream law and economics. Indeed, even though there were different views how to achieve the maximation of social welfare, there was no doubt on the methodology to say what the law should be. Behavioral law and economics broke the curse and comparative analysis has no more a single reliable model to refer to. The enforcement of penalty clauses is generally considered efficient, but several cognitive biases should be assessed: overconfidence, unrealistic optimism, availability, etc. Despite the fragmentation of the efficient model, it may be still useful narrowing down the comparison on some specific aspects: for instance, the evaluation of the amount of the forfeited damage, where the efficiency depends on the criterion used by the judge. Embracing a comparative law and economics approach, the article aims to consider the last thirty years case law of different legal systems as well as the harmonization international projects concerning the law of penalty clauses.

I. INTRODUCTION

Penalty clauses have been the subject of several comparative law studies[1], as well as of numerous law and economics analyses[2]. Indeed, these clauses are age-old known[3], and the legal systems developed different doctrines about them, influenced by the remarkable

---

[1] *Ex multis*, see P. Benjamin, *Penalties, Liquidated Damages and Penal Clauses in Commercial Contracts: A Comparative Study of English and Continental Law*, in 9 Int. & Comp. L. Q. 600-627 (1960); J. Thilmany, *Fonctions et révisibilité des clauses pénales en droit compare*, in Rev. int. Dr. Comp. 17 (1980); M. Santaroni, *Spunti comparatistici in tema di clausola penale*, in P. Cendon (ed.), *Scritti in onore di Rodolfo Sacco*, Vol. I (Milano: Giuffrè, 1994), 1059 ff.; A. Russo, *Inadempimento e clausola penale tra* civil law *e* common law (Napoli: Jovene, 2012); I.M. García, *Enforcement of Penalty Clauses in Civil and Common Law: A Puzzle to be Solved by the Contracting Parties*, in 6 Eur. J. Legal Stud. 83 (2013).

[2] *Ex multis*, see C.J. Goetz and R.E. Scott, *Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach*, in 77 Colum. L. Rev. 554-594 (1977); P.R. Kaplan, *A Critique of the Penalty Limitation on Liquidated Damages*, in 50 South. Calif. L. Rev. 1055-1090 (1977); K.W. Clarkson, R.L. Miller and T.J. Muris, *Liquidated Damages v. Penalties: Sense or Nonsense?*, in Wis. L. Rev. 351-390 (1978); P.H. Rubin, *Unenforceable Contracts: Penalty Clauses and Specific Performance*, in 10 J. Leg. Stud. 237-247 (1981); S.A. Rea Jr., *Efficiency Implications of Penalties and Liquidated Damages*, in 13 J. Leg. Stud. 147-167 (1984); L.A. Stole, *The Economics of Liquidated Damage Clauses in Contractual Environments with Private Information*, in 8 J. Law Econ. Organ. 582-606 (1992); J. Thorpe, *Economists Divided - Different Perceptions of Contracts Penalty Doctrine*, in 6 Bond L. Rev. 189-209 (1994); L.A. Di Matteo, *A Theory of Efficient Penalty: Eliminating the Law of Liquidated Damages*, in 38 Am. Bus. L. J. 633-733 (2001); A.S. Edlin and A. Schwartz, *Optimal Penalties in Contract*, in 78 Chi.-Kent L. Rev. 33-54 (2003).

[3] M. Scognamiglio, *La clausola penale nell'esperienza giuridica romana*, in S. Cherti (ed.), *La pena convenzionale nel diritto europeo* (Napoli: Jovene, 2013), 1 ff.; S. Gialdroni, *La clausola penale tra finzione e realtà. Il caso limite di Shylock alla prova del diritto veneziano, del diritto comune e del* common law, *ibid.*, 19 ff.

implications on some milestones of the contract law theory, such as the parties' freedom, the contractual performance, the remedies against the breach of contract[4]. Thereby the private law comparatists' interest in this field is self-explanatory, but also the economic standpoint is easily understandable due to the effects the forfeited damage clauses may have on the efficient allocation of risks and resources[5].

In 1995, an influential scholar examined the different approach of common law and civil law on penalty clauses in contracts, with the aim of assessing which one is the least divergent from the model built on the efficiency standards. After an in-depth analysis, the conclusion was that, in this area, "civil law can be considered less inefficient than common law"[6]. Taking into account the arguments used by this author, the present work seeks to deal with two valuable questions.

First, it is worth wondering whether there have been changes influencing the efficient model and, if so, whether there is still a model which works as a uniform term of comparison for the real-world solutions of different legal systems. Secondly, changes might affect not only the premise, but also the conclusion: even though there were not significant legislative reforms on penalty clauses over the last years, it is well known that the case law is able to (at least, partially) alter the starting points giving rise to new convergences or divergences among the above-mentioned legal systems. Therefore, this article aims to assess whether civil law countries can still be considered less inefficient than common law legal systems and whether the efficiency goals have attracted more attention during the last decades than in the past.

The paper will be structured as follows. In the first part, I will introduce the earlier comparative law and economics analysis on penalty clauses. Then, I will examine what has changed thereafter: the rise of behavioral economics and the new case law as well as the harmonization European and international projects on this law field. With regard to the former, I will recognize that comparative law and economics is still useful despite the fragmentation of the efficient model. Due to the latter changes, I will conclude by arguing that civil law cannot be considered less inefficient than common law on penalty clauses anymore and the harmonization projects adopt an inadequate compromise solution.

---

[4] A. Zoppini, *La pena contrattuale* (Milano: Giuffrè, 1991), 99 ff.; F.P. Patti, *La determinazione convenzionale del danno* (Napoli: Jovene, 2015), 101 ff.; L. Klesta Chabaud, *Pena ed esecuzione patrimoniale: la clausola penale nella riforma francese del diritto delle obbligazioni*, in Nuova giur. civ. comm. 1189 (2020).

[5] R. Pardolesi, *Analisi economica e diritto dei contratti*, in Pol. dir. 699, 723 ff. (1978); Patti, *supra* note 4, 78.

[6] U. Mattei, *The Comparative Law and Economics of Penalty Clauses in Contract*, in 43 Am. J. Comp. L. 427, 441 (1995). Along this line, with similar or new arguments, see also A.N. Hatzis, *Having the cake and eating it too: efficient penalty clauses in Common and Civil contract law*, in 22 Int. Rev. L. Econ. 381 (2003); L. Di Matteo, *Behavioural Case for Contractual Penalties under the Common Law*, in 23 Eur. Rev. Priv. L. 327 (2015).

II. THE PREVIOUS COMPARATIVE LAW AND ECONOMICS ANALYSIS ON PENALTY CLAUSES

The distinction between civil law and common law about a specific institution can turn out to be an over-simplification where the major differences lie beyond the national systems belonging to the two legal families. With regard to penalty clauses, however, it makes sense because the original approach is rather antithetic at a macro level[7].

In common law, penalty clauses are not enforceable, as opposed to liquidated damages clauses. The doctrine against penalties has its roots in the equitable jurisdiction; then, the concrete rules found their consolidation in many seminal cases[8] and, as to the United States, also in the Uniform Commercial Code (§ 2-718) and the Second Restatement of Contracts (§ 356). The core of this doctrine obviously concerns the tests by which penalties are distinguished from liquidated damages, so that the case law plays a crucial role. On the other hand, notwithstanding some differences, the civil law countries share the idea according to which penalty clauses are not invalid, but their amount can be reduced by the courts if they deem it grossly excessive[9]. Thus, the judicial power is also relevant in this legal area.

Both legal systems are assumed to be inefficient because of the unjustified barriers to contractual freedom[10]. Indeed, restrictions are needed if the parties' behaviors create externalities or there are other market failures that require regulation; where these circumstances do not occur, parties' agreement is presumed to be rational[11]. The exceptional cases of irrationality, due to the lack of genuineness of consent, should be handled by the normal contract law remedies, such as the doctrines of unconscionability, misrepresentation, duress, and mistake, or the fairness principle, depending on the legal system which is involved. To be honest, the conventional law and economics' view is not uniform on penalty

[7] Anyway, an author would rather distinguish four legal models on penalty clauses: the actual French model; the Napoleonic model; the Pandectist model; the common law model (Santaroni, *supra* note 1, 1060-1061). See also García, *supra* note 1, 90, who stresses the differences in rules governing contract penalties between civil law countries. Moreover, the Belgian system is closer to the common law model than to the (general) civil law approach: see Zoppini, *supra* note 4, at 77.

[8] In the English common law, the traditional leading case has so far been *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd* (1915) A.C. 79. In sec. VI, we will see how the Supreme Court of the United Kingdom partially changed the previous approach.

[9] In the majority of European civil law systems, the judicial modification of penalty clauses is based on the grounds of equity. Spanish law differs from this model, allowing the judge to moderate the penalty only if there has been partial performance by the debtor. See García, *supra* note 1, 86 ff.

[10] Mattei, *supra* note 6, 430, 435 ff.

[11] J.H. Barton, *The Economic Basis of Damages for Breach of Contract*, in 1 J. Leg. Stud. 277, 283 ff. (1972); R.A. Epstein, *Beyond Foreseeability: Consequential Damages in the Law of Contract*, in 18 J. Leg. Stud. 105, 106 (1989).

clauses[12], but the majority of scholars argued in favor of enforcing them[13]. The efficient model used by Mattei was built on this background. In particular, the endorsement for penalty clauses is traditionally based on the following arguments.

According to a famous theory, a penalty clause works as the best insurance against the subjective consequences of breach within those contests where the idiosyncratic values are unlikely to be recovered. The promisor is the most efficient insurer because s/he is the subject who can manage the risk (avoiding the breach of contract) at the lowest cost[14]. Moreover, the penalty clause can function also as a signal for a promisor's reliability, and it is useful to reduce the transaction costs affecting the newcomers in the market who have not built up a reputation yet[15]. More generally, when parties enter into the contract without private information, stipulated damages may be used to communicate valuable information at the pre-contractual stage, serving a dual role of promoting efficient breach and increasing the likelihood of trade[16]. Further, some scholars have argued that penalty clauses should be enforced as contract termination options, that serve important risk management functions[17]. Although the concrete solutions adopted by common law and civil law are far from the efficient model, Mattei stated a preference for the latter one. The exceptional nature of the penalty reduction was invoked as the decisive argument. Indeed, because of that, litigation aimed at re-examining the possibility of introducing penalties is discouraged. Besides, if the penalty is grossly excessive, the court will not enter a judgement that merely obliges the promisor to pay the actual damages (i.e., one that merely forces him/her to internalize). This means that "[t]he promissor under penalty does not pass from penalty to internalization; s/he passes from a higher penalty to a reduced one. S/he therefore receives an incentive to invest in proper and timely performance, to the point at which the marginal cost of precaution equals the marginal benefit of alternative investments (e.g., on entertain another customer) minus the amount of penalty s/he will in any case incur. Within these limits, the civilian model allows penalties to perform their efficient purpose"[18].

---

[12] Against enforcing penalty clauses, it was argued that they will deter parties from committing efficient breaches (R.A. Posner, *Economic Analysis of Law* (Frederick: Aspen Publishing, 2014), 141). Moreover, penalties could incentivize to attempt to induce a breach by the other party (Clarkson *et al.*, *supra* note 2, 661), leading to a larger number of disputes (Rubin, *supra* note 2, at 243f.).

[13] See M. Pressman, *The Two-Contract Approach to Liquidated Damages: A New Framework for Exploring the Penalty Clause Debate*, in 7 Va. L. & Bus. Rev. 651, 665 (2013); L.S. Marquard, *An Empirical Study of the Enforcement of Liquidated Damages Clauses in California and New York*, in 94 South. Calif. L. Rev. 637, 641 (2021).

[14] Goetz and Scott, *supra* note 2, 578 ss. About the importance of penalty clauses to compensate subjective costs, see also L. De Alessi and R.J. Staaf, *Subjective Value in Contract Law*, in 145 J. Institutional Theor. Econ. 561 (1989).

[15] Cf. R.A. Posner, *supra* note 12, at 142.

[16] Stole, *supra* note 2, 584 ff.

[17] R.E. Scott and G.G. Triantis, *Embedded Options in the Case Against Compensation in Contract Law*, in 104 Colum. L. Rev. 1428-1491 (2004).

[18] Mattei, *supra* note 6, 442f..

Under common law, conversely, a contract clause which imposes an amount disproportionate to the estimate of damages in the event of breach is not enforced at all. Consequently, the promisor will "invest in timely and efficient performance only to the point at which his marginal investment equals the probability that a Court will not recognize the penalty as such. He therefore receives a much greater incentive to perform poorly and to litigate in case of bad performance"[19].

III. Mainstream law and economics vs behavioral law and economics: the new insights on penalty clauses

The so far described efficient model is premised on the idea that contracting parties are rational decision makers. It is assumed that they follow their self-interest and achieve the maximation of joint profit and social welfare, absent transaction costs or other objective market constraints, such as externalities. Within this frame, penalty clauses should be basically enforced because parties know their interests and needs better than judges. In the last decades, however, these assumptions have been criticized: defining what self-interest means is problematic and many law and economics studies have been influenced by cognitive psychology[20]. The focus shifts on the contracting parties' bounded rationality in making decisions. Accordingly, legal analysis requires new insights that should give consideration to heuristics and subjective biases, such as overoptimism, overconfidence, availability, hindsight bias, ambiguity aversion, anchoring, framing, endowment effect, hyperbolic discount, etc.[21]. From this perspective, penalty clauses met new opponents advocating for a wider legal paternalism. In general terms, it was noted that "the inherent complexity of determining the application of a liquidated damages provision to every possible breach scenario is often likely to exceed actors' calculating capabilities"[22]. According to another scholar, the existing ban of penalty clauses is justified because contracting parties are usually overoptimistic about their ability to perform the contract[23]. However, as to the enforceability of these clauses, the status of the contracting parties is considered relevant to identify the debiasing mechanisms. An

[19] *Id.*, at 443.
[20] J.L. Harrison, *The Influence of Law and Economics Scholarship on Contract Law: Impressions Twenty-Five Years Later*, in 68 N.Y.U. Ann. Surv. Am. L. 1, 8 ff. (2012).
[21] *Ex multis*, see C.R. Sunstein, *Behavioral Analysis of Law*, in 64 U. Chi. L. Rev. 1175, 1182 ff. (1997); R.B. Korobkint and T.S. Ulen, *Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics*, in 88 Cal. L. Rev. 1051, 1084 ff. (2000); R.A. Epstein, *Behavioral Economics: Human Errors and Market Corrections*, in 73 U. Chi. L. Rev. 111 (2006).
[22] M.A. Einsenberg, *The Limits of Cognition and the Limits of Contract*, in 47 Stand. L. Rev. 211, 227 (1995).
[23] J.J. Rachlinski, *The "New" Law and Psychology: A Reply to Critics, Skeptics, and Cautious Supporters*, in 85 Cornell L. Rev. 739, 763 (2000).

author highlights that the utmost account shall not be taken to the distinction between businesses and consumers, but between parties with hierarchical organization and those not organized in this fashion. Indeed, the pressure of accountability and the outside view of the problem favor judgments not affected by individual biases, such as overoptimism, overconfidence, and the illusion of control[24]. However, even workers can make a decision by adapting to the inside view of the problem of their superiors. To this end, it should be necessary to carry out evaluations on a case-by-case basis, avoiding any types of generalization but giving rise to grave uncertainty[25].

On the other hand, behavioral decision theory is also used to strongly support the enforcement of penalty clauses. It was argued that, when the negotiators have a relatively equal bargaining power, penalties serve as rational response to bargaining irrationality. Their negotiation is conceived as one device that parties use to deal with the uncertainty of timely performance and the behavioral biases stemming from past experiences involving this ever-present condition[26]. Moreover, an experimental study shows that stipulating the damages in the contract helps parties reconceptualize their obligations in such a way that they are willing to exploit efficient-breach opportunities as they are less likely to find the breach morally offensive[27]. Meanwhile, there is also experimental evidence that a forfeited damage clause providing a small amount can give rise to inefficient incentives[28].

Behavioral law and economics sheds light on some critical aspects of contract penalties' regulation[29]; however, as has been seen, its lessons are often conflicting, and its normative position is quite ambiguous[30]. Despite being the more immediate solution against bounded rationality, a wider paternalism should not be broadly generalized since cognitive limits do not affect every human agent in the same way and could require different regulatory strategies[31]. Besides, biases may also influence the judicial decisions[32].

---

[24] E. Baffi, *Efficient Penalty Causes with Debiasing: Lessons from Cognitive Psychology*, in 47 Val. U. L. Rev. 993, 1005 ff. (2013).
[25] *Id.*, at 1016.
[26] L.A. Di Matteo, *Penalties as Rational Response to Bargaining Irrationality*, in Mich. St. L. Rev. 883 (2006).
[27] T. Wilkinson-Ryan, *Do Liquidated Damages Encourage Breach? A Psychological Experiment*, in 108 Mich. L. Rev. 633 (2010).
[28] A. Gaviria, *El efecto de las cláusulas penales en las decisiones de incumplimiento. Un análisis bajo la economía conductual*, in Rev. de Derecho Priv. 59, 72 ff. (2018).
[29] For a detailed overview, see Patti, *supra* note 4, 85 ff.
[30] See R.A. Hillman, *The Limits of Behavioral Decision Theory in Legal Analysis: The Case of Liquidated Damages*, in 85 Cornell L. Rev. 717, 733 ff. (2000).
[31] About some criticisms against a regulatory model built only on the individual rationality, see F. Denozza, *Mercato, razionalità degli agenti e disciplina dei contratti*, in Oss. dir. civ. comm. 1, 5 ff. (2012).
[32] R.A. Hillman, *supra* note 30, 735 ff.

IV. THE FRAGMENTATION OF THE EFFICIENT MODEL: IS COMPARATIVE LAW AND ECONOMICS STILL USEFUL?

The previous section showed how much the identification of an efficient model on penalty clauses in contracts has become tricky. Cognitive psychology brought down the myth of the rational agent and put under pressure the assumptions of mainstream economic analysis of law. This paradigm shift should be examined within the frame of comparative law and economics. Indeed, it could be argued that the uncertainty about the efficient rules undermines the objective of the discipline: using efficiency to evaluate legal transplants[33]. This observation prompts the question whether the comparative law and economics works without a clear efficient model which reveals how the law should be.

To this end, it is worth bringing out the key features of the normative dimension of comparative law and economics, that suggests the appropriate legal transplants and how they should and can be made[34]. It means that absolute statements are not needed, unlike the economic analysis of law which aims to identify the rules which are ideal in terms of efficiency. Comparison, instead, implies a relative judgement. Among two or more legal rules, it is possible to state the rule which is less inefficient despite the lack of consensus about the most efficient one at all. For instance, a concrete legal solution can be both efficient, considering some features, and inefficient, looking at some others; on the contrary, another real-world rule can prove to be inefficient in any case. Indeed, "[i]n using the tools of law and economics together with those of comparative law, the notion of efficiency assumes itself a comparative meaning. […] Consequently, the notion of efficiency, as used in comparative law and economics, maintains a clearly dynamic meaning, strictly linked with the notion of legal change"[35]. Hence, the insights from behavioral sciences do not alter the function of comparative law and economics.

In this context, penalty clauses represent an interesting case study. According to Mattei, "[i]n the efficient model, penalty clauses should not be treated differently from any other clause. And this should also apply to standard contracts"[36]. Not enforcing the clauses in question is justified only "if their introduction is unconscionable: for example because they have been introduced surreptitiously, or if they have been accepted by a party unable to understand

---

[33] About the objective of comparative law and economics, see U. Mattei *et al.*, *Comparative Law and Economics*, in B. Bouckaert and G. de Geest (eds.), *The Encyclopedia of Law and Economics Volume One: The History and Methodology of Law and Economics* (Cheltenham: Edward Elgar, 2000), 508.
[34] *Id.*, at 507.
[35] *Id.*, at 512 f.
[36] Mattei, *supra* note 6, at 431.

their significance"[37]. This scheme, enacted by the Napoleonic code[38], cannot be considered the perfect guide anymore. Behavioral economics teaches us that broad generalizations have shortcomings. A judicial reduction of the stipulated sum is not necessarily inefficient, as well as the non-enforcement could be effectively dissuasive against unfairness resulting from abuses of information asymmetry or cognitive biases, pursuing justice and efficiency at once[39]. The key point is how (i.e. according to which criteria) the judges exercise their power on penalty clauses. With regard to their reduction in civil law, three aspects are decisive: when a penalty clause is grossly excessive and so when it may be reduced[40]; the time reference for this evaluation (*ex ante* or *ex post* as to the time of contract conclusion); the benchmark for the (new) sum amount in making the reduction. Moreover, despite the inefficiency of common law penalty rule, there is no doubt that it will be less inefficient if the ban of penalties is interpreted restrictively. Therefore, analysing case law about these aspects is crucial to assess legal trends towards or away from economic arguments.

V. COMPARATIVE CASE LAW ON THE JUDICIAL REVIEW OF PENALTY CLAUSES: OPPOSITE TRENDS BETWEEN CIVIL LAW AND COMMON LAW

Among civil law jurisdictions, Italian case law was one of the most active about penalty clauses during the last decades. For this reason, utmost attention shall be paid to Italian court judgements. In particular, the Supreme Court overturned its decisions on two basic points.

In the absence of an explicit provision establishing that the judge may act on his own motion, before 1999 it was not disputed that a judge could reduce a grossly excessive penalty clause only upon the request of the non-breaching party. The first-time admission of an *ex officio* judicial intervention[41] was confirmed by the Grand Chamber of the Supreme Court in 2005[42]. This overruling was much criticized on the grounds of economic arguments[43]. Under an ever-present judicial reduction power, penalty clauses are not able to compensate subjective costs anymore. Indeed, parties are someway deprived of the freedom to assess their interests

[37] *Id.*, at 430 f.
[38] *Id.*, at 434.
[39] This is the rationale beyond the invalidity of unfair terms, including penalty clauses, in business-to-consumer contracts: see P. Iamiceli, *sub* Art. 1382, in E. Gabrielli (ed.) *Commentario del codice civile* (Torino: Utet, 2011), 960.
[40] To be honest, in most civil law countries penalty clauses may be also reduced if the main contract obligation has been performed. In this case, the judicial reduction is quite predictable and does neither change the parties' will nor affect economic efficiency. See A. Palmieri, *La riducibilità «ex officio» della penale e il mistero delle «liquidated damages clauses»*, in Foro it., I, 1930, 1935 (2000).
[41] Corte di Cassazione 24 September 1999, n. 10511, in Foro it., I, 1929 (2000).
[42] Corte di Cassazione, sezioni unite, 12 September 2005, n. 18128, in Foro it., I, 2985 (2005).
[43] A. Palmieri, *Supervisione sistematica delle clausole penali: riequilibrio (coatto ed unidirezionale) a scapito dell'efficienza?*, in Foro it., I, 106 (2006); *Id.*, *supra* note 38, 1930 ff.; A. Bitetto, *Riduzione ex officio della penale: equità a tutti i costi?*, in Foro it., I, 432 (2006).

because they are always subject to the judge's approval. It is worth noting that the *ex officio* judicial intervention is expressly recognized also by the French Civil Code (Article 1231-5, which replaced Articles 1152 and 1231 due to *Ordonnance* n° 2016-131 of 10 February 2016). However, the judge may on her own motion even increase the agreed penalty, where it is ridiculously low. This solution is slightly less inefficient than the Italian one due to the advantage of tackling liability-limiting clauses, which deprive the parties of all incentives to perform properly[44].

Another important decision of the Italian Supreme Court concerns the issue of the relevant point in time for the evaluation of the excessiveness of the penalty[45]. Article 1384 of the Italian Civile Code states that the judicial reduction of the penalty should take into account the interest that the creditor had in contract performance. Courts have often considered the conclusion of the contract as the relevant moment for the evaluation because of the presence of the verb in the past tense[46]. This interpretation was abandoned in 2012, since the Supreme Court decided to consider also what happens until the moment of judgement for assessing whether a penalty is excessive[47]. Even if the actual damage suffered by the creditor is not the only benchmark that matters[48], clearly this new approach emphasizes the compensatory function of the stipulated damages clauses in spite of the punitive dimension[49]. As the penalty agreements become more uncertain, efficiency is again disregarded[50]. The *ex post* evaluation of the penalty has side effects: it can induce the promisor to get extra money for the "insurance", that will not be enforced when the damages turn out to be lower than the sum due as penalty[51]. The French case law shares the same shortcomings; moreover, in this legal system the actual loss suffered by the non-breaching party is used by the case law as the yardstick for the judicial review[52]. Giving relevance to the actual loss, the penalty can be reduced up to zero, or little more (actually, the sum may not be reduced below the damages

44 Palmieri, *supra* note 43, 108. About the French regulation, see D. Mazeaud, *Clause pénale*, in D. Mazeaud, R Boffa and N. Blanc (eds.), *Dictionnaire du contrat* (Issy-les-Moulineaux: LGDJ, 2018).
45 Corte di Cassazione 6 December 2012, n. 21994, in Foro it., I, 1205 (2013).
46 See F.P. Patti, *Penalty Clauses in Italian Law*, in Eur. Priv. L. Rev., 321 (2015).
47 The overruling was confirmed in the following decision: Corte di Cassazione 19 June 2020, n. 11908, in Rep. Foro it., Contratto in genere, atto e negozio giuridico, n. 369 (2020).
48 *Ex multis*, see Corte di Cassazione 7 September 2015, n. 17731, in Rep. Foro it., Contratto in genere, atto e negozio giuridico, n. 372 (2015).
49 Patti, *supra* note 46, at 322.
50 A. Palmieri, *Art. 1384 c.c. e sopravvenienze: ulteriore arretramento della funzione sanzionatoria della clausola penale*, in Foro it., I, 1212 (2013).
51 A. Palmieri and R. Pardolesi, *Dalla parte di Shylock: vessatorietà della clausola penale nei contratti dei consumatori*, in Danno e responsabilità 272, 276 (1998). About the different economic impacts between *ex ante* and *ex post* assessment of penalties, see S.A. Rea, Jr., *Efficiency Implications of Penalties and Liquidated Damages*, in 13 J. Leg. Stud. 147-167 (1984).
52 Patti, *supra* note 4, at 429.

payable for failure to perform the obligation), when there is no evidence of damages[53]. Further, Italian case law takes into account only the financial creditor's interest[54], though penalty clauses should be efficient tools to safeguard idiosyncratic values[55].

As well as Italian and French case law, other civil law jurisdictions proved to achieve inefficient solutions. For example, the Dutch Supreme Court (the *Hoad Raad*) delivered two important decisions (*Monda/Hauer I* and *Monda/Hauer II*) about a "lump-sum penalty clause", which sanctions each and every breach of contract by the same penalty. Thus, it does not matter whether the debtor has committed a serious breach of contract or a minor one. The cases concerned a sales contract where for each violation of a contractual obligation, regardless of the sort of obligation, by either buyer or seller, an amount of 10% of the purchase price (fl. 90,000) had to be paid[56]. Despite the differences between the two judgements (the second one is less radical than the previous one), both undermined the principle whereby the judicial power to reduce a penalty should be applied reluctantly. With regard to lump-sum penalties, modification is now the starting point. Indeed, the burden of proof has shifted on the creditor who has to justify why the lump-sum penalty may not be reduced[57].

Whilst several civil law countries have become more suspicious about penalty clauses, the trend is opposite in some common law jurisdictions[58]. Special consideration shall be taken to the United Kingdom Supreme Court's decision of the joint appeals in *Cavendish v El Makdessi* ("Makdessi") and *ParkingEye v Beavis* ("ParkingEye"). It serves as a new landmark for the penalty rule in English law, moving away from *Dunlop*[59]. The latter was composed of four principles set out by Lord Dunedin, who outlined also four tests to assist a court in making its decision as to whether a sum stipulated is penalty (unenforceable) or liquidated damages (enforceable). Dunedin's second proposition has been relied upon the most by subsequent courts: "The essence of a penalty is a payment of money stipulated as *in terrorem* of the offending party; the essence of liquidated damages is a genuine covenanted pre-estimate of damage"[60]. In *Makdessi* and *ParkingEye* the UK Supreme Court dismissed the "genuine pre-estimate of loss" approach in favour of a test whereby a contractual provision may be a penalty if: it is a secondary obligation which imposes a detriment on the contract-breaker out

[53] Santaroni, *supra* note 1, at 1065 f.
[54] Corte di Cassazione 5 August 2002, n. 11710, in Contratti 336 (2003).
[55] The German civil code (§ 343, BGB) is more efficient on this point: In judging the appropriateness of the agreed sum, every legitimate interest of the obligee, not merely his financial interest, must be taken into account.
[56] See H. Schelhaas, *The judicial power to reduce a contractual penalty*, in 12 ZEuP 386 (2004).
[57] *Id.*, at 392.
[58] Along these lines, see E. Calzolaio, *Il nuovo volto della clausola penale nel diritto inglese*, in Contratti 817, 822 (2016).
[59] See *supra* note 8.
[60] See L.K.C. Leung, *The Penalty Rule: A Modern Interpretation*, in 29 Denning L. J. 41, 46 (2017).

of all proportion to any legitimate interest of the innocent party in the enforcement of the primary obligation. Thus, the key-element is the legitimate commercial interest of the non-breaching party in performance. It is worth highlighting that "the concepts of genuine pre-estimate of loss and deterrence that had once been at the heart of the rule are notably absent"[61]. Moreover, the Supreme Court stated that where both parties are of comparable bargaining power and are properly advised (by solicitors), there is a strong initial presumption that the parties themselves are the best judges of what is legitimate in provisions dealing with the consequences of breach[62]. Although the Supreme Court did not abandon the penalty rule nominally, the rule is now "de facto extinct"[63]. There is no explicit evidence that law and economics has influenced the overruling, but the *Makessi* and *ParkingEye* test on penalties seems to be less inefficient than the *Dunlop* one. At least, legitimate commercial interest in performance is taken into account.

Other common law jurisdictions, such as Australia and Ireland, are faced with the new English approach, but convergencies and divergencies are still discussed by legal scholars[64].

In the United States, the distinction between liquidated damages and penalties is illustrated by both the Uniform Commercial Code (§2-718) and the Second Restatement of Contracts (§356). According to them, penalty is a term fixing unreasonably large liquidated damages and its reasonableness must be evaluated *ex ante* and *ex post* the contract conclusion. Besides, some States have regulated the treatment of liquidated damages clauses and penalty clauses by statutes[65]. With this regard, a recent study shows that, notwithstanding some differences in laws and doctrines, California and New York courts share similar approaches as to stipulated damages. In California law, for contracts other than those ones involving consumer goods and services and leases of residential property, "the [penalty] rule has been relaxed and liquidated damages clauses are now presumptively valid, 'unless the party seeking to invalidate the provision establishes that the provision was unreasonable under the circumstances existing at the time the contract was made'"[66]. In New York law, there is the same presumption of validity for liquidated damages valid. Moreover, the New York courts are reluctant to interfere with parties' agreements and "frequently look at the sophistication

[61] *Id.*, at 47.
[62] *Id.*, at 48 f..
[63] W. Day, *A Pyrrhic Victory for the Doctrine against Penalties: Makdessi v Cavendish Square Holding BV*, in 2 J. Bus. L. 115 (2016).
[64] See C. McEneaney, *Penalty Clauses and Liquidated Damages: The Divergence in English and Irish Jurisprudence*, in 8 KILR 1 (2019); M. Yip and Y. Goh, *Convergence between Australian common law and English common law: The rule against penalties in the age of freedom of contract*, in 46 Common L. World Rev. 61 (2017).
[65] See, for example, California: Marquard, *supra* note 13, at 646.
[66] *Ibid.*

of the parties and procedural aspects, such as negotiation, relative bargaining power, and whether the parties were represented by counsel. Many courts stated that contracts resulting from arms-length negotiations by sophisticated parties are entitled to judicial deference"[67]. In comparison with English jurisprudence, American courts are generally more influenced by law and economics scholarship, even though its impact is not always clear. However, an author highlighted that the role of the economic literature has been evident in the case of liquidated damages clauses. Indeed, courts have relatively frequently cited the article by Charles Goetz and Robert Scott, "and in this instance the law seems to be on the move as well"[68].

The examined case law demonstrates how both UK and US common law are moving towards more flexibility on penalty clauses. The new enforceability tests are not fully consistent with economic arguments not being properly transparent and introducing a certain degree of uncertainty into the contracting process due to the strict distinction between primary and secondary obligations[69]. Nevertheless, the new benchmarks are less inefficient than the civil law ones as addressed by national courts.

VI. HARMONIZATION PROJECTS ON PENALTY CLAUSES: AN UNSATISFACTORY COMPROMISE

Differences between legal systems have been described so far. The most direct tool to overcome them is notoriously harmonization. In the last decades, there were several initiatives at the European and international level on harmonizing contract law, involving the treatment of penalty clauses. Moreover, these clauses are often included in international commercial contracts and there has long been a need for legal convergence about them: the Resolution of the Council of Europe on Penal Clauses in Civil Law was adopted in 1978[70]. Although harmonization projects belong to soft law, it is worth assessing their regard for efficient legal solutions. This way we can see whether an economic rationale has been taken into account by the expert committees about the law of *ex ante* stipulation of damages. We draw attention to the provisions adopted after Mattei's analysis; thereby, we only look at the

[67] *Id.*, at 650.
[68] Harrison, *supra* note 20, at 21.
[69] About some criticisms against the *Makessi* test, cf. McEneaney, *supra* note 61, 28 ff.; E. Calzolaio, *supra* note 56, 820.
[70] Council of Europe, Resolution (78) 3 relating to penal clauses in civil law, adopted by the Committee of Ministers on 20 January 1978, at the 281st meeting of the Ministers' Deputies.

rules included in the Principles of European Contract Law[71] (art. 9:509), the Draft Common Frame of Reference[72] (art. III.-3:712) and the UNIDROIT Principles[73] (art. 7.4.13).

These rules are almost identical and as a consequence share pros and cons. About the first, there is no distinction between liquidated damages clauses and penalty clauses, so that an agreed payment for non-performance is enforceable regardless of its function[74]. Anyway, on the tracks of civil law tradition, the stipulated sum may be reduced to a reasonable amount. On the other hand, the provisions are not detailed, and many questions have no explicit answer. For instance, it is not clear whether the judge can reduce the penalty on his own motion (*ex officio*)[75]. As has been seen before, the presence of this further judicial power would lead to inefficient outcomes. Moreover, the proposed law moves away from efficiency opting for an *ex post* excessiveness test, since the stipulated sum is considered grossly excessive in relation to the loss resulting from the non-performance and the other circumstances. Another possible shortcoming for efficiency goals concerns the notion of "loss". Indeed, a scholar argues the following point about the DCFR's provision on penalties: "If 'loss' is intended to refer to the sum which a court is likely to award in an objective assessment, the rule may constitute a serious impediment to efficient contracting, since the stipulated sum may reflect a very high subjective interest in performance which courts in practice would be reluctant to recognise"[76].

This brief overview shows that harmonization projects, clearly influenced by a compromise rationale, do not seem to embrace the economic perspective on penalty clauses more than the national systems do. At least, there is large room for judicial interpretation.

VII. Conclusions

In 1995, penalty clauses were subject to a comparative law and economics analysis, the conclusion of which was that in this field civil law is less inefficient than common law. The ban of penalties along with the enforcement of liquidated damages clauses has been

[71] O. Lando and H. Beale (eds.), *Principles of European Contract Law*, Parts I and II (The Hague, London, Boston: Kluwer Law International, 2000).
[72] C. von Bar *et al.* (eds.), *Principles, Definitions and Model Rules of European Private Law*, *Draft Common Frame of Reference* (DCFR) (Munich: Sellier, 2009).
[73] International Institute for the Unification of Private Law, *UNIDROIT Principles of International Commercial Contracts*, (Rome: UNIDROIT, 2016).
[74] F.P. Patti, *Contratti internazionali e clausola penale: esigenze di armonizzazione*, in Cherti, *supra* note 3, at 246.
[75] *Id.*, at 251 f.
[76] A. Ogus, *Measure of Damages: Expectation, Reliance and Opportunity Cost*, in F. Chirico and P. Larouche (eds.), *Economic Analysis of the DCFR – The work of the Economic Impact Group within the CoPECL* (Munich: Sellier, 2009), 140.

considered a stronger barrier to efficiency more than the judicial reduction of grossly excessive penalties is. To this end, the main argument was the exceptional nature of the civil law judicial modification in coherence with the freedom of contract principle, which was instead completely constrained by the common law penalty rule.

Almost three decades later, the previous conclusion should be overturned. Even though English and American courts continue to follow the distinction between liquidated damages and penalties, they have refrained from applying the rule strictly. The *Makessi* and *ParkingEye* tests of the UK Supreme Court placed emphasis on the aspects of commercial justification of stipulated damages overlooking the specific amount of the agreed sum. California and New York courts usually give relevance to the parties' bargaining power: when the latter is relatively equal, the forfeited damage clause is more likely to be enforced.

Conversely, several civil law courts are not anymore reluctant to reduce stipulated damages. The recognition of an *ex officio* judicial intervention where the agreed damages are deemed to be unreasonable, the adoption of *ex post* evaluation and the invalidity presumption of lump-sum penalty clauses push towards the uncertainty of parties' agreement regardless of economic concerns. Indeed, these general changes (i.e. not limited to specific situations) cannot be justified on the grounds of the new insights coming from behavioral law and economics. Although they may advocate for more paternalism, tackling cognitive biases would require different tools, that need a preliminary identification of the vulnerable agents and of the market sectors more frequently subject to failures. Moreover, as Mattei already noted, "neither are reasons in terms of justice intuitive, unless we are willing to believe that fairness requires decision-making biased towards the debtor-defendant"[77]. In light of that, there are no significant reasons to follow the new civil law trend. Eventually, this article briefly examined European and international harmonization projects on contract law. The compromise solutions adopted by them are not very satisfactory in terms of efficiency.

[77] Mattei, *supra* note 6, at 443.