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Jeremy Thorpe

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Economists Divided - Different Perceptions of Contracts Penalty Doctrine

Abstract
While proponents of 'law and economics' can reasonably agree on theories such as efficient breach and efficient common law, the application of these theories to the penalty doctrine has divided the faithful into two groups: those who would keep the penalty doctrine - the retentionists - and those who would do away with the doctrine - the abolitionists. While these categorisations are not internally consistent, nor the boundaries between them entirely clear, such a classification is a useful aid to understand the economic consideration of the penalty doctrine.

A surprising omission in the reshaping of the penalty doctrine is the courts failure to explicitly consider the academic economic analysis of the penalty doctrine. This article sets out the key arguments that the courts can (and should) consider in an economic analysis of the penalty doctrine.

Keywords
contract law, penalty doctrine, economics

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Thanks to Kevin Nicholson for comments on an earlier draft. The views expressed in this article are those of the author and not necessarily those of the Industry Commission.

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ECONOMISTS DIVIDED – DIFFERENT PERCEPTIONS OF CONTRACT'S PENALTY DOCTRINE

By
Jeremy Thorpe*
Economist
Office of Regulation Review
Industry Commission (Canberra)

When contracting parties have agreed on the damages to be payable upon breach, the plaintiff may seek to recover the agreed damages[1] rather than his or her actual loss. The penalty doctrine looks at the validity of this agreed damages clause by determining whether, at the time of the contract's formation, the clause was a genuine pre-assessment of loss.[2] If the agreed damages were not a genuine pre-estimate then the court deems the clause penal and will strike it down and substitute its own assessment of damages.

The penalty doctrine is being recast; its discretionary scope whittled away.[3] In a quest for contractual certainty courts have turned away from general notions of fairness, instead stressing the genuine pre-estimate test. The equitable character of the doctrine, however, is not lost. More in line with modern notions of unconscionability, the penalty doctrine now incorporates a good faith requirement that is subservient to the genuine pre-estimate test.

Given that 'Most [penalty] cases involve theories of costing that may be more appropriate for ... economists than for lawyers',[4] it is not surprising that economics has infiltrated academic consideration of the penalty doctrine.[5] While proponents of 'law and economics' can reasonably agree on theories such as efficient breach and efficient common law, the application of these theories to the penalty doctrine has divided the faithful into two groups: those who would keep the penalty doctrine – the retentionists – and those who would do away with the doctrine – the abolitionists. While these categorisations are not internally consistent, nor the boundaries between them entirely clear, such a

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1 It is equally valid to refer to agreed damages as liquidated damages.

2 *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd* [1915] AC 79 at 86 per Lord Dunedin.

3 The penalty doctrine is also being recast in other ways. For the use of agreed damages clauses as a means of elevating a mere contractual right to terminate to the status of an essential term see Nicholson K, (1988) 1 *JCL* 64.

4 Allan D and Hiscock M, *Law of Contract in Australia* 2nd ed (1992) CCH, Melbourne, at 85.

5 '[T]he use of economic analysis in legal scholarship has become so *de rigueur* that even those who refuse to view economics as the Holy Grail of knowledge are compelled to use economics in their scholarship': Seita A, 'Common Myths in the Economic Analysis of Law' (1989) *BYU L Rev* 993 at 997. For similar sentiments see Posner R, 'The Decline of Law as an Autonomous Discipline: 1962-1987' (1987) 100 *HLR* 751; Posner R, 'Richard T Ely Lecture: The Law and Economics Movement' (1987) 77(2) *American Economic Review* 1; Stigler G, 'Law or Economics?' (1992) 35 *J Law & Econ* 455; Williams S, 'Legal Versus Non-Legal Theory' (1994) 17 *Harvard Journal of Law and Public Policy* 79; Heyne P, *The Foundations of Law and of Economics: Can the Blind Lead the Blind?* (1984) speech at the Australian National University, Thursday 18 October.

classification is a useful aid to understand the economic consideration of the penalty doctrine.

A surprising omission in the reshaping of the penalty doctrine is the courts failure to explicitly consider the academic economic analysis of the penalty doctrine. This article sets out the key arguments that the courts can (and should) consider in an economic analysis of the penalty doctrine.

A brief outline of the penalty doctrine

Despite the penalty doctrine's long lineage,[6] the current law of penalties began with *Clydebank Engineering and Shipbuilding Co v Don Jose Ramos Yzquierdo Yquierdo Y Castaneda*.[7]

> [I]f you find a sum of money payable for the breach, ... and when you find that the sum payable is proportioned to the amount ..., or the rate of non-performance of the agreement ... then you infer that prima facie the parties intended the amount to be liquidate [sic] damages and not penalty. I say 'prima facie' because it is always open to the parties to show that the amount named in the clause is so exorbitant and extravagant that it could not possibly have been regarded as damages for any possible breach which was in the contemplation of the parties, and that is a reason for holding it to be a penalty and not liquidate damages ...[8]

Lord Davey made it clear that the court's assessment of damages is to be made at the time of the contract's formation:

> That is to say, you are to consider whether it is extravagant, exorbitant or unconscionable, what-ever word you like to select, at the time when the stipulation is made – that is to say, in regard to any possible amount of damages or any kind of damages which may be conceived to have been within the contemplation of the parties when they made the contract.[9]

Lord Dunedin in *Dunlop*[10] picked up the reasoning of *Clydebank* and set out a series of propositions that remain the foundation of today's penalty doctrine. Like Lord Davey, Lord Dunedin was concerned with the substance of an agreed damages clause rather than its form:

> Though the parties to a contract who use the words 'penalty' or 'liquidated damages' may prima facie be supposed to mean what they say, yet the expression used is not conclusive. The Court must find out whether the payment stipulated is in truth a penalty or liquidated damages.[11]

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6 Rossiter traces the penalty doctrine from fifteenth century calls for equitable relief against penal bonds with conditional defeasance: Rossiter C, *Penalties and Forfeiture* (1992) Law Book Company, Sydney, at 1.

7 [1905] AC 6 per Lord Davey.

8 Ibid at 16.

9 Ibid at 17.

10 Above n 2.

11 Ibid. The promisor has the onus of proof in establishing that the agreed damages clause was something other than the contract described it: *Robophone Facilities Ltd v Blank* [1966] 1 WLR 1428 at 1447.

This sought to overcome the 18th and 19th Century judicial approach that determined whether an agreed damages clause was penal by construing the contracting parties' intention as reflected in the contractual description of the agreed damages.[12] Instead of seeking to rely on the intention as set out in the contract:

> The question whether a sum stipulated is penalty or liquidated damages is a question of construction to be decided upon the terms and inherent circumstances of each particular contract, judged as at the time of the making of the contract, not as at the time of breach ...[13]

In *Dunlop* Lord Dunedin set out the test to determine whether an agreed damages clause was penal in nature:

> 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* ...[14]

It is the second limb (italicised) that is the heart of the modern penalty doctrine. Some commentators make the error of placing too much emphasis on Lord Dunedin's applications of the genuine pre-estimate test[15] as though they were the key to the penalty doctrine.[16] Such an approach is incorrect as 'these tests were clearly proffered as subsidiary to the central issue of whether or not there was a genuine pre-estimate'.[17] Similarly, McGregor supports the centrality of the pre-estimate criteria as 'all the following tests stem from it and are subordinate to it'.[18]

While acknowledging the genuine pre-estimate test, Australian courts eroded the *Dunlop* principle that relief should only be granted if the agreed damages are exorbitant or unconscionable. Instead, courts struck down clauses

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12 *Wallis v Smith* (1882) 21 Ch D 243 per Sir George Jessel.

13 Above n 2, 86-87 per Lord Dunedin.

14 Ibid at 86 per Lord Dunedin. Emphasis added.

15 Ibid at 87-88 per Lord Dunedin:

> To assist this task of construction various tests have been suggested, which if applicable to the case under consideration may prove helpful, or even conclusive. Such are:
>
> (a) It will be held to be a penalty if the sum stipulated for is extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have followed from the breach ...
>
> (b) It will be held to be a penalty if the breach consists only in not paying a sum of money, and the sum stipulated is a sum greater than the sum which ought to have been paid ... This though one of the most ancient instances is truly a corollary to the last test ...
>
> (c) There is a presumption (but no more) that it is penal when a single lump sum is made payable by way of compensation, on the occurrence of one or more or all of several events, some of which may occasion serious and others but trifling damage. ...
>
> On the other hand:
>
> (d) It is no obstacle to the sum being a genuine pre-estimate of damage, that the consequences of the breach are such as to make precise pre-estimation almost an impossibility. On the contrary, that is just the situation when it is probable that pre-estimated damage was the true bargain between the parties.

16 Ham A, 'The Rule Against Penalties in Contract: An Economic Perspective' (1990) 17 *Melbourne University Law Review* 649 at 651.

17 Above n 32.

18 McGregor H and Mayne J, *McGregor on Damages* 15th ed (1988) Sweet & Maxwell, London, at 284.

where the agreed damages *may* have exceeded the amount that a court would award for the breach in question. For example, in *Citicorp v Hendry*[19] Priestly JA held an agreed damages clause to be penal because there was a chance of a windfall gain if a breach occurred early in the contact's life; Priestly JA was playing hypotheticals. Such an approach incorrectly looked to see whether the pre-estimate was accurate at the time of breach rather than at formation.

The High Court halted this trend in *AMEV-UDC v Austin*[20] and *Esanda v Plessnig*.[21] It called for a return to the central tenet of *Dunlop* to allow parties greater freedom in reaching agreements without judicial interference:

> [T]he concept is that the agreed sum is a penalty if it is 'extravagant, exorbitant or unconscionable' ... This concept has been eroded by more recent decisions which, in the interests of greater certainty, have struck down provisions for the payment of an agreed sum merely because it may be greater than the amount of damages which could be awarded for the breach of contract in respect of which the agreed sum is to be paid. These decisions are more consistent with an underlying policy of restricting the parties ... to the recovery of an amount of damages no greater than that for which the law provides. However, there is much to be said for the view that the courts should return to the *Clydebank Engineering* and *Dunlop* concept, thereby allowing parties to a contract greater latitude in determining what their rights and liabilities will be ...[22]

In *AMEV-UDC* Mason and Wilson JJ made the case for increased freedom of contract. They claimed that certainty is enhanced by allowing parties to more precisely determine their rights and liabilities on breach or termination. This allows one party to compensate the other party for any loss that is difficult to quantify or that is not recoverable at common law. This has the potential to avoid costly and time-consuming litigation.

While lauding freedom of contract, Mason and Wilson JJ clarify when a court will intervene to classify an agreed damages clause as penal. They emphasise that it is the essence of a penalty that an agreed sum is penal only if it is extravagant, exorbitant or unconscionable and therefore out of all proportion to the damage likely to be suffered as a result of the breach. They held that the test

> is one of degree and will depend on a number of circumstances, including (1) the degree of disproportion between the stipulated sum and the loss likely to be suffered by the plaintiff, a factor relevant to the oppressiveness of a term to the defendant, and (2) the nature of the relationship between the contracting parties, a factor relevant to the unconscionability of the plaintiff's conduct in seeking to enforce the term.[23]

In *Esanda* Wilson and Toohey JJ rejected the proposition that the mere

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19 [1985] 4 NSWLR 1 at 35.

20 (1986) 162 CLR 170.

21 (1989) 166 CLR 131.

22 Above n 20, 190 per Mason and Wilson JJ. This passage was approved by Wilson and Toohey JJ in *Esanda v Plessnig*: Ibid at 139.

23 Above n 20, 193.

possibility of unfairness in the calculation of agreed damages is sufficient to characterise it as penal.[24] They argued that 'The adoption of such a criterion fails to allow for the latitude that necessarily attends the conception of a genuine pre-estimate of damage.'[25] After referring to *Esanda* and *AMEV-UDC*, Lord Woolf in the Privy Council expressed a similar view (which, I submit, coincides with the Australian position):

> As is the case with most commercial contracts, there is always going to be a variety of different situations in which damage can occur and even though long and detailed provisions are contained in a contract it will often be virtually impossible to anticipate accurately and provide for all the possible scenarios. Whatever the degree of care exercised by the draftsman it will still be almost inevitable that an ingenious argument can be developed for saying that in a particular hypothetical situation a substantially higher sum will be recovered than would be recovered if the plaintiff was required to prove his actual loss in that situation. Such a result would undermine the whole purpose of parties to a contract being able to agree beforehand what damages are to be recoverable in the event of a breach of contract. This would not be in the interest of either of the parties to the contract since it is to their advantage that they should be able to know with a reasonable degree of certainty the extent of their liability and the risks which they run as a result of entering into the contract.[26]

The essence of Lord Woolf's judgement is that 'hypothetical situations should not be given too much weight in assessing stipulated damages sums'.[27] This indicates the move away from the *Citicorp v Hendry* approach[28] – the courts have warned against attacks on agreed damages clauses with the wisdom of hindsight on the ground that the actual loss turns out to be less than the pre-estimated sum.[29]

The penalty doctrine remains, but as a limited power to strike down agreed damages only when they are not a genuine pre-estimate of the loss, a return to the spirit of the *Dunlop* test.

A partial 'law and economics' primer

It is not surprising that contract law should be of interest to economists; economics is essentially the study of exchanges and contract law regulates such exchanges. While far from uniform in their consideration of contract law generally, economists share a core set of principles: roughly categorised as the

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24 Above n 21, 141-142.
25 Ibid at 142.
26 *Phillips v Attorney General of Hong Kong*, Unreported; 9 February 1993, from Hong Kong. Transcript at 6.
27 Smith S, 'Contract' in Pettet (ed), *Current Legal Problems 1994* (1994) Oxford University Press, London, 5 at 23.
28 Discussed at n 19.
29 *O'Dea v Allstates Leasing System (WA) Pty Ltd* (1983) 152 CLR 359 at 400 per Deane J; Above n 20, 193 per Mason and Wilson JJ. See also *AMEV Finance Ltd v Artes Studios Thoroughbreds Pty Ltd* (1989) 15 NSWLR 564 at 566, 575 per Kirby P and Clarke JA.

common law efficiency theory and the notion of efficient breach.[30]

The efficient common law theory

As a broad generalisation, it is fair to say that the law and economics proponents support the positive theory of efficient common law – that judges make law as if maximising social welfare.[31]

> What we may call the efficiency theory of the common law is not that *every* common law doctrine and decision is efficient. That would be highly unlikely given the difficulty of the questions that the law wrestles with and the nature of judges' incentives. The theory is that the common law is best (not perfectly) explained as a system for maximising the wealth of society.[32]

This notion of wealth maximisation evolves from an understanding of the Kaldor-Hicks conception of efficiency.[33] From a Kaldor-Hicks perspective, an allocation of resources is efficient if the gains and losses can be redistributed so that, in theory, no individual will be worse off and at least one person better off. This method asks whether those who gain from a decision would, in theory, be willing to compensate the losers.[34] This approach maximises society's net income 'when goods and other resources are in the hands of those who value them most, and someone values a good more if and only if he is both willing and able to pay more in money (or the equivalent of money)'.[35]

Efficient breach

To facilitate the free movement of resources to their most valuable uses contracts should be breached when it is efficient to do so under the Kaldor-Hicks criterion.[36] For example, if A owns a good that B values more, then both

30 For a good description of what people may refer to when discussing the 'law and economics' movement see Friedman D, 'Law and Economics' in Eatwell J, Milgate M and Newman P (eds), *The New Palgrave: A Dictionary of Economics* (1987) Macmillan, London, at 144-148.

31 Posner R, *Economic Analysis of Law* (4th ed 1992, Little Brown and Company, Boston) at 23-28, 31-32 and 251-236. The positive theory focuses on how judges make the law; the normative theory focuses on how judges *should* make the law. For discussion of the normative theory see Posner R, 'Utilitarianism, Economics and Legal Theory' (1979) 8 *J Legal Stud* 103; Posner R, *The Economics of Justice* (1981) Harvard University Press, Cambridge, at 60-115; Posner R, 'Wealth Maximisation Revisited' (1985) 2 *Journal of Law, Ethics & Public Policy* 85. The normative theory is much more contentious than the positive theory, and suffered correspondingly more criticism: Dworkin R, 'Is Wealth a Value?' (1980) 9 *J Legal Stud* 191; Cunningham W, 'Testing Posner's Strong Theory of Wealth Maximisation' (1992) 81 *Georgetown LJ* 141; Stephen F, *The Economics of the Law* (1988) Wheatsheaf, Brighton, at 194-209.

32 Posner R, *Economic Analysis of Law* 4th ed (1992) Little Brown and Company, Boston, at 23.

33 See Posner R, *The Economics of Justice* (1981) Harvard University Press, Cambridge, at 88-99; ibid at 12-16.

34 Although this notion of efficiency acknowledges that some parties will suffer losses, it does not require the winners to compensate the losers. For a more detailed explanation of the Kaldor-Hicks notion of efficiency see B Fischoff and L Cox, 'Conceptual Framework for Regulatory Benefits Assessment' in Bentkover J, Covello V and Mumpower J (eds) *Benefits Assessment: The State of the Art* (1986) D Reidel Publishing, Boston, at 63-65.

35 Dworkin R, 'Is Wealth a Value?' (1980) 9 *J Legal Stud* 191 at 191.

36 This statement of efficient breach relies on the view that 'The duty to keep a contract at common law means a prediction that you must pay damages if you do not keep it – and nothing else.' Holmes O, 'The Path of Law' (1897) 10 *HLR* 457 at 462. This view assumes freedom to enter into a contract and freedom to exit a contract. Quite correctly, critics argue that this is a narrow view of

A and B will be made better off by an exchange of A's good for B's money (or equivalent) at any price between A and B's valuations. However, once an agreement to exchange is made, circumstances may change so that A and/or B is better-off not completing the exchange. Such a change in circumstances can occur in two ways. First, A may be placed in a situation where breaching the contract and supplying to a third party may bring greater returns. Such a situation arises when a third party offers to purchase the good for a price greater than the price which was contracted for between A and B. In this case, A should sell to the third party.

Second, after A and B contractually agree, circumstances may change so that either A or B might be put in a position where completing the contract puts them in a worse position than going through with it. If, after the contract is entered into, A discovers that the material costs have risen dramatically, A may wish not to complete the contract because A will lose money. It would be a misuse of resources to force completion of the contract; it is no-longer value maximising.[37]

These two simple examples of so-called efficient breach lack one important consideration; to ensure only efficient breaches the breaching party should compensate the breached-against party for his or her lost profits.[38] Such a proviso ensures that every breach is value-maximising. For example, if in the first case the damages B suffers because of breach are greater than the price differentials then breach will have caused a net decline in welfare. Damages are vital as a means of internalising the external effects created by breach. Thus, the accuracy of the damages payable upon breach will have an important bearing on whether or not a breach is efficient. The more inaccurate the assessment of damages (whether agreed to by the parties or imposed by courts), the greater the number of inefficient breaches or the lower the number of efficient breaches.

Law and economics scholars have studied alternative remedies to determine whether they might promote efficient breaching more effectively than traditional damage awards. The use of agreed damage clauses is one such alternative remedy considered by academics. However, different opinions abound as to whether the penalty doctrine conforms to the efficiency theory of common law by facilitating efficient breach, or whether, as Posner puts it, the penalty doctrine retards efficient breach and so constitutes 'a major unexplained puzzle in the economic theory of the common law.'[39]

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contract because it eschews, amongst others, the moral arguments such as those espoused by Fried: Fried C, *Contract as a Promise* (1981) Harvard University Press, Cambridge – and the view of a contract as a relationship, espoused particularly by Macneil and Macaulay: see Gordon R, 'Macaulay, Macneil, and the Discovery of Solidarity and Power in Contract Law' (1985) *Wisconsin LR* 565. The 'narrow' approach adopted in this article greatly simplifies the economic analysis of the penalty doctrine.

37 An aid to conceptualising when breach is efficient is to place the contracting parties within a single vertically integrated firm. The welfare-maximising action for the firm, in this example, would be to halt production.

38 Stephen F, *The Economics of the Law* (1988) Wheatsheaf, Brighton, at 160.

39 Posner R, 'Some Uses and Abuses of Economics in Law' (1979) 46 *U Chi LR* 281 at 290.

Two 'law and economics' approaches to the penalty doctrine

The abolitionists

At the heart of the abolitionist arguments is the claim that the freedom to agree on the level of damages creates certainty. This certainty enables parties to minimise transaction costs, share risk between contracting parties and incorporate difficult or idiosyncratic values into the calculation of damages.

Dissatisfaction with the judicial assessment of damages

Abolitionist arguments tend to reassess the pre-eminent position given to damage provisions. Brightman argues that contracting parties should be able to exert the same freedom in shaping the terms of an agreed damages clause as they exert in shaping the terms of any other contractual term.[40] Similarly, Epstein argues that

> Damage rules are no different from any other terms of a contract. They should be understood solely as default provisions subject to variation by contract. The operative rules should be chosen by the parties for their own purposes, not by the law for its purposes.[41]

This adopts the view, supported by Polinsky, that the rule in *Hadley v Baxendale* may be a suitable default liability rule in many situations (such as when the costs of formulating an agreed damages clause is excessive) but will be less desirable in some circumstances.[42] When those circumstances arise the parties should be free to contract out of expectation damages and free to substitute an alternative damages measure. It can be argued that Baron Alderson in *Hadley v Baxendale*[43] supports such a proposition:

> For, had the special circumstances been known, the parties might have specially provided for the breach of contract by special terms as to the damages in that case; and of this advantage it would be very unjust to deprive them.[44]

Dissatisfaction with judicial approaches to the determination of damages creates, as Landes and Posner see it, the essential rationale for the continued use of agreed damages clauses:

> If ... the substantive rules or the procedures of the public courts were inefficient, substitution away from dispute resolution would take place. An

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40 Brightman A, 'Liquidated Damages' (1925) 25 *Columbia LR* 277 at 302.

41 Epstein R, 'Beyond Foreseeability: Consequential Damages in the Law of Contract' (1989) 18 *J Legal Stud* 105 at 108.

42 Polinsky A, 'Risk Sharing Through Breach of Contract Remedies' (1983) 12 *J Legal Stud* 427 at 444.

43 (1854) 9 Exch 341.

44 Ibid at 355. Waddams claims that this quote hints at a raw economic approach to damages: Waddams S, *The Law of Damages* (1983) Canada Law Book, Toronto, at 670.

> example of the substitution possibilities is the liquidated-damages clause, whereby the parties substitute a damage-assessment formula of their own choosing for whatever rules of contract damages or methods of damage assessment the courts employ. The more costly or less accurate the judicial methods of damage assessment, the more we would expect parties to resort to liquidated-damages clauses. Thus, in principle at least, ebbs and flows in popularity of such clauses could be used to measure the efficiency of judicial damage-assessment methods.[45]

Landes and Posner flag two situations when agreed damages clauses will be popular: when judicial approaches are more costly than private damage assessments, and when the judicial damage assessments is inaccurate in comparison with the parties' assessment. These two circumstances are inherently intertwined,[46] but can be considered separately.

Firstly, by determining the level of damages at the time of contracting, the parties may be able to reduce the transaction costs by reducing reliance on later judicial intervention. The classic example of when agreed damages are favoured is when damages are uncertain or difficult to establish. The harder to quantify loss the more costly proving loss will be. Furthermore, limitations are imposed on the recovery of consequential loss and even reasonably foreseeable loss that is too uncertain to quantify. Thus, agreed damages clauses avoid the difficult process of quantifying uncertain loss, but at the plaintiff's expense. Even when the parties have attempted to resolve the uncertainty with a stipulated sum, as efficiency dictates, the penalty doctrine increases transaction costs again by relating the sum to the maximum uncertain loss possible before enforcing the agreement.

As Stole argues, the courts acknowledge the potential cost savings of allowing the parties to determine the level of damages when the parties under-stipulate the level of damage suffered.[47] The courts will not strike down an agreed damages clause that under-compensates the party, even though it may be regarded as having failed the judicial criteria of being a genuine pre-estimate.[48] This, Stole argues, occurs when one or either of the parties has private information. The court accepts in such circumstances that the contracting parties are best placed to determine their level of damages. On this basis, the judicial treatment of clauses that overcompensate is incompatible with under-compensation. With increasing court costs,[49] acknowledging that the parties may be in a position to more cheaply calculate damages than the courts, hence

45 Landes W and Posner R, 'Adjudication as a Private Good' (1979) 8 *J Legal Stud* 235 at 253.

46 For example, if a great deal of money is spent trying to calculate damages then the accuracy will improve.

47 Stole L, 'The Economics of Liquidated Damage Clauses in Contractual Environments with Private Information' (1992) 8 *The Journal of Law, Economics, & Organisation* 582.

48 An Australian example of where the 'penalty' provision was less than the provable damages is *Pascoe-Webbe v Nusana Pty Ltd* (1985) (unreported) 1 BPR 92399.100, per Young J in the NSW Supreme Court.

49 One can hypothesise that the increased calls for the abolition of the penalty doctrine is a response to the increased cost of litigation (both financial and opportunity cost). For the costs of litigation see Williams P and Williams R, 'The Cost of Civil Litigation: An Empirical Study' (1994) 14 *International Review of Law and Economics* 73.

promoting an efficient means of breach, is a sound endorsement of the abolition of the penalty doctrine and support for freedom of contract.[50]

Secondly, Landes and Posner argue that agreed damages may be contemplated when the judicial assessment of damages calculated under the rule of *Hadley v Baxendale*[51] differs to the real loss suffered. The rule in *Hadley v Baxendale* was stated by Alderson B:

> Where two parties have made a contract which one of them has broken, the damages which the other party ought to receive in respect of such breach of contract should be such as may fairly and reasonably be considered either arising naturally, ie, according to the usual course of things, from such breach of contract itself, or *such as may reasonably be supposed to have been in the contemplation of both parties, at the time they made the contract, as the probable result of the breach of it*.[52]

The difficulty encountered with the second limb of *Hadley v Baxendale* (in italics above) is determining to what extent the defendant must have agreed to accept the risk of the damage. Although there is no longer a requirement that there must be a term of the contract indicating acceptance of the risk by the defendant, agreed damages serve to make it clear what damages were in the contemplation of the parties at the time of contracting.[53]

Couched in terms of transaction costs, the use of agreed damages clauses serves an important function because

> if it is socially desirable that sellers possess information enabling them to distinguish between buyers' types, then high valuation buyers alone should communicate their valuation to sellers; ... This way of transferring information minimises transaction costs. ... [H]igh valuation buyers will find it beneficial to identify themselves to secure full protection against breach even though they will have to pay a higher contract price.[54]

For a number of reasons the court's assessment of loss to the plaintiff may differ from that actually suffered. This may mean that a stipulated damages clause that would fully compensate is not enforced, and an inadequate award is substituted.[55] Thus the court's inference of unfairness in their attitude to

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50 '... the very existence of a freely negotiated agreed damages provision is compelling evidence that it constitutes the cost-minimising alternative': Goetz C and Scott R, 'Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach' (1977) 77 *Columbia LR* 554 at 587.

51 Above n 43.

52 Ibid at 354. Italics added.

53 Carter J and Harland D, *Contract Law in Australia* 2nd ed (1991) Butterworths, Sydney, at 721.

54 Bebchuk L and Shavell S, 'Information and the Scope of Liability for Breach of Contract: The Rule of *Hadley v Baxendale*' (1991) 7 *The Journal of Law, Economics, & Organisation* 284 at 285-286. If the producer or supplier accepts increased liability, the contract price will rise by the discounted future payments multiplied by the probabilities of occurrence of the costly outcomes, the liability of which is additionally assumed. Alternatively, if the purchaser acknowledges the lower value placed on performance and accepts a lower agreed damages sum, the purchase price will generally fall by an amount equal to the probability of unfavourable outcomes multiplied by the expected costs to the purchaser.

55 Shavell S, 'The Design of Contracts and Remedies for Breach' (1984) 99 *Quarterly Journal of Economics* 121.

agreed damages clauses for what they consider to be excessive amounts may not be warranted, and refusing to enforce such clauses may impose more costs than it removes.

For example, one party may attach unusual and subjective value to performance which would be rejected by a court as too fanciful to recover. When the promised performance has a market value to which the promisee attaches an additional idiosyncratic value then he or she may be paying a premium on the market price, but will require an agreed level of damages that exceeds the market price.[56] Evaluated after breach, such subjective loss is regarded as too speculative and uncertain to be recovered in the courts.[57]

Risk management

Risk management is a fundamental rationale for the formation of contracts. Although not specifically referred to by Landes and Posner,[58] the use of contracts for risk management can explain why private notions of damage vary from judicial notions. A simple contract to exchange goods for money at a future date manages risk by hedging the price so that both parties bear the risk of a change in the good's price. In a similar manner one can argue that agreed damages serve as a means of hedging against future changes in the liability of the parties.

Parties have different degrees of risk aversion and may wish to negotiate agreed damages so that the less risk-averse party at least partially insures the more risk-averse against loss from breach.[59] The most obvious example of this is in contracts where a new contractor is competing against established rivals. While lowering a tender price may secure a deal it may also imply to the consumer a lower quality good or service. A solution may be to insure the consumer against default; a 'penal' damages assessment establishes good faith that the good or service will be delivered.[60] Thus a risk premium may be attached, possibly on top of the industry standard agreed damages clause. This is just an example of non-price competition; the new contractor is communicating credible information about his or her reliability.[61]

A penalty clause may simply compensate the seller for a high risk of default. Suppose defaulting buyers will often be insolvent or otherwise be

56 Goetz and Scott, 'Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach' (1977) 77 *Columbia Law Review* 554 at 578-593. For an abbreviated discussion of the Goetz and Scott Dean Smith example see Furmston M, 'Contract Planning: Liquidated Damages, Deposits and the Foreseeability Rule' (1991) 4 *JCL* 1 at 7; *Contract Planning: Liquidated Damages, Deposits and the Foreseeability Rule* (1990) University of Adelaide Law School, Continuing Legal Education Papers, No. 62, at 13-14.

57 Of course, such a limitation is justified where the costs of establishing an agreed value of the idiosyncrasy exceeds the cost of an inaccurate measure of damage.

58 Above n 45.

59 Clarkson et al suggest another class of risk management, where subjective perceptions of probabilities of risk differ: Clarkson K, Miller R and Muris T, 'Liquidated Damages v Penalties: Sense or Nonsense?' (1978) *Wisconsin Law Review* 351 at 367.

60 An alternative response to ensure the quality of the good once delivered may be to extend the warranty over a good.

61 Above n 32, 129.

unable to cover the seller's full damages. Then the 'windfall' recovery of a penalty in some cases will, by offsetting losses incurred in others, enable sellers to take greater risks and charge lower prices.[62] While theoretically possible, this argument lacks credibility because there is nothing to suggest that they will take greater risks.[63]

Polinsky has shown that in some instances it is efficient from a risk-allocation viewpoint to contract for stipulated damages in excess of the actual loss from breach.[64] Such conditions require, among other things, that the buyer should bear some of the price risk introduced from third-party, breach inducing offers. Rea, however, argues that these conditions are rare.[65]

The retentionists

The proponents of law and economics who defend the penalty doctrine do so from the opposition benches; the cohesion of the abolitionist approaches nowhere to be seen.

'Obstinate insistence on the enforcement of certain penalties may result in a failure to exploit efficiency gains by inducing the penalised party not to breach.'[66] For example, suppose that A has a product which B agrees to pay $100 for upon delivery.[67] B values the product at $120. That is, B enjoys a $20 consumer surplus. If a third party then offers A $150 the potential exists for efficient breach; A can sell to the third party, fully compensate B for B's lost consumer surplus and still be $30 better off.[68] Now, suppose agreed damages are set at $60.[69] This agreed damages provision is penal in nature because the agreed damages ($60) are set above B's consumer surplus ($20) – this is not a genuine pre-estimate. To be better off A wants to sell the product to the third party but not pay B anything greater than $50. B's threat to enforce the agreed damages clause means that A will not sell the good to the third party. Thus, the person who really most values the good does not have it; a non-efficiency-maximising outcome. The better situation would have been for A and B to negotiate an agreed damages level between $20 and $50 so that each party gains. Negotiation in this range can be regarded as constituting a genuine pre-estimate of an agreed damages clause.

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62 Ibid at 129.

63 The argument is analogous to the claim that a monopolist, because of access to greater funds, will be able to devote more funds to research and development, hence creating more innovative products for consumers.

64 Above n 42.

65 Rea S, 'Efficiency Implications of Penalties and Liquidated Damages' (1984) 13 *J Legal Stud* 147 at 154.

66 For a more fully developed example see Clarkson, Miller and Muris, 'Liquidated Damages v Penalties: Sense or Nonsense?' (1978) *Wisconsin Law Review* 351 at 358-363.

67 For a more fully developed example see above n 59, 358-363.

68 This example ignores the fact that B will likely have to pay more than $100 for the product from an alternate supplier and will possibly suffer costs due to a delay in receiving the product. Thus, full compensation may require A to pay B more than the $20 which constituted B's original consumer surplus. This increased cost does not affect the effectiveness of the example as long as B's costs do not exceed $50. If they do then there is no scope for an efficient breach.

69 Liquidated damages clauses will only hinder efficient breach if the third party offers an amount that lies between the original purchase price and the original purchase price plus the agreed damages. See above n 59, 360-362.

A less abstract way to highlight the potential for penalty clauses to stifle efficient breach is to consider the possible effect of 'golden-parachutes' on corporate takeovers.[70] A 'golden parachute' is, in essence, an agreed damages clause that compensates managers for the loss of their jobs in the event of a merger or takeover. An excessive amount of compensation in golden-parachutes could induce social inefficiencies by blocking some efficient takeovers (where the benefit of merging is less than the payouts required for management).[71]

A related argument is that if agreed damages exceed expectancy then the party who would benefit from breach will try and induce a breach, or will more assiduously monitor to determine if breach has occurred. Again using the example of 'golden parachutes', managers who will gain from a merger because of the existence of a generous golden parachute may encourage a merger even if such a merger is not efficient. Similarly, the party who would lose from a breach will have to devote resources to ensuring that breach does not occur, or to attempting to cover-up any breach. Clarkson et al argue that 'Resources spent both on breach-inducing activities and on detecting and preventing breach inducement are wasteful.'[72]

While the retentionists agree that a penalty doctrine is necessary, some do not necessarily favour the doctrine as promulgated by the courts. For example, Clarkson et al argue that the genuine pre-estimate test should be prefaced by the requirement that it is only applied 'When contracting parties can covertly increase the probability of breach and when they might have incentive to do so...'.[73] As a general guide Clarkson et al categorise agreements that do not increase the probability of breach and where there is no incentive to create breach as clauses that deal with limits on damages, accords after breach, clauses for a breach of covenant not to breach, and clauses where the sole relationship between the parties is that of borrower and lender.[74] Alternatively they categorise those clauses that provide the opportunity and the incentive to induce breach as clauses for delay in construction, for the forfeiting upon breach of money paid at the contract's formation, and clauses that stipulate damages despite being drafted as an alternative contract.[75]

Rea is critical of Clarkson et al's distinction. He argues that their rationale for the penalty doctrine ignores the effect of agreed damages on the promisor's incentives. The promisor's efforts to avoid breach will be excessive if circumstances have changed so as to make the predetermined damages large in light of actual losses and deficient if the agreed damages are small in light of the actual losses. Therefore, there are efficiency costs of inaccurate damages

70 This anecdote is drawn from Chung T, 'On the Social Optimality of Liquidated Damages Clauses: An Economic Analysis' (1992) 8 *The Journal of Law, Economics, & Organisation* 280 at 300.

71 Compare with Machlin J, Choe H and Miles J, 'The Effects of Golden Parachutes on Takeover Activity' (1993) 36 *J Law & Econ* 861.

72 Above n 59, 370. Emphasis removed.

73 Ibid at 375.

74 Ibid at 383-387.

75 Ibid at 388-390.

regardless of the promisee's possible ability to induce breach.[76]

Rubin has provided one explanation for the penalty doctrine.[77] He argues that an agreed damages clause which is not a penalty is self-enforcing, meaning that it is unlikely to result in litigation. On the other hand, an agreed damages clause which clearly is extravagant and penal is productive of litigation as one party has an incentive to induce non-performance. The cost of the ensuing litigation is inefficient and one which the public should not subsidise. The court, by declining to enforce such penal clauses, may in fact be contributing to efficiency.

Rea, on the other hand, has argued that economists who have been puzzled by the penalty doctrine have failed to note the difference between agreed damages which are unreasonable or extravagant pre-estimates and those which are unreasonably large ex post breach.[78] In the former case, he argues, there are no economic reasons for enforcing such a clause because

> it appears that the penalty doctrine is not as anomalous as has been generally believed. The heart of the doctrine is that those damage clauses that were unreasonably large ex ante will not be enforced. A careful examination of the factors influencing predetermined contractual damages suggests that there are few instances in which excessive damages will be desired by the contracting parties. The courts are correct in viewing such clauses with suspicion. Their refusal to enforce the clauses when losses can be easily measured is consistent with the doctrines of mistake and unconscionability.[79]

Another line of discussion is critical of the effects of penalty clauses on third parties. Firstly, penalties increase the risk of bankruptcy consequent on contractual default; increasing the number and total cost of bankruptcies.[80] If penalty clauses were common then this greater chance of bankruptcy may increase the amplitude of the business cycle.[81] Secondly, penalty clauses may act as a barrier to entry for competitors. While abolitionists argue that new entrants to an industry can establish goodwill by providing a premium in the form of a penal agreed damages clause,[82] if incumbents provide a penal agreed damages clause then new entrants may be denied the ability to compete effectively.[83]

On these analyses, the use of agreed damages creates a clear trade-off – it protects expectancy, but at the risk of reducing potential efficient breaches or, in some cases, encouraging breaches which are not efficient when all costs and benefits are weighed.

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76 Above n 65, 166. Rea makes the further point that an explanation for the penalty doctrine based on breach incentives is not consistent with the enforcement of under-liquidated damages.

77 Rubin P, 'Unenforceable Contracts: Penalty Clauses and Specific Performance' (1981) 10 *J Legal Stud* 237.

78 Above n 65.

79 Ibid at 162-163.

80 Resource costs and not just pecuniary losses: Above n 65, 129-130.

81 Farber D, 'Contract Law and Modern Economic Theory' (1983) 78 *Nw UL Rev* 335.

82 See above n 32, 129.

83 Above n 32.

Squaring off – the judiciary, the abolitionists and the retentionists

How then does the preceding discussion of the abolitionist and retentionist positions fit in with present judicial views? One must be careful in answering this question as initial views can be deceptive.

The continued existence of the penalty doctrine must give retentionists heart, and correspondingly, give abolitionists reason for complaint. However, this black and white position is weakened when one considers the character of the doctrine as it exists after *AMEV-UDC v Austin*.

Equity – out with the old

It is quite clear that the penalty doctrine no longer relies upon general equitable principles. Gibbs CJ put it thus:

> The appellant cannot successfully seek to rely on general equitable principles which relate to the relief against penalties when those principles have long since hardened into definite rules governing the position of parties to a contract which contains a clause imposing a penalty for breach.[84]

The definite rules that Gibbs CJ refers to is in fact a liberalised *Dunlop* test:

> [W]hen a court does examine whether an agreed damages clause is penal, it looks to ascertain whether the clause was a genuine pre-estimate of loss at the time of the making of the transaction in the light of general conditions prevailing in the particular industry or market rather than having regard to the particular or peculiar circumstances of the person seeking relief.[85]

Despite claiming that the penalty doctrine is devoid of discretion and relies upon common law rules, Wilson and Mason JJ still see a general supervisory role for equity:

> the [penalty] doctrine's historic antecedents, the concept is that the agreed sum is a penalty if it is 'extravagant, exorbitant or unconscionable' .... But equity and the common law have long maintained a supervisory jurisdiction, not to rewrite contracts imprudently made, but to relieve against provisions which are so unconscionable or oppressive that their nature is penal rather than compensatory. The test to be applied in drawing that distinction is one of degree and will depend on a number of circumstances, including (1) the degree of disproportion between the stipulated sum and the loss likely to be suffered by the plaintiff, a factor relevant to the oppressiveness of the term to the defendant, and (2) the nature of the relationship between the contracting parties, a factor relevant to the unconscionability of the plaintiff's conduct in

84 Above n 176. See also Mason and Wilson JJ.

85 Above n 6, viii. Rossiter is critical of this abandonment of an equitable jurisdiction in light of the historical development of the penalty doctrine

seeking the term.[86]

This statement is consistent with the High Court's stance during the 1980s of redefining previous doctrines in general terms of unconscionability.[87] Accepting that procedural forms of unconscionability[88] are able to strike out an agreed damages clause, the question then becomes whether the references made by Mason and Wilson JJ refer to some other form of unconscionability.

The first role that has been suggested for Mason and Wilson JJ's unconscionability is as an alternate test to the genuine pre-estimate test. While acknowledging the common law rules to determine the existence of a penalty doctrine, Meagher JA claims that Wilson and Mason JJ in *AMEV*[89] appear to support:

> A second line of authorities ... that [suggest] relief against penalties is in its nature, discretionary, so that the nature of the relationship between the contracting parties may make the contractual stipulation in question unconscionable.[90]

This interpretation is flawed.[91] It is important to stress that the notions of unconscionability referred to by Mason and Wilson JJ are subservient to, and must be accommodated within the genuine pre-estimate test. It is wrong to apply discretionary notions of unconscionability at the time of breach rather than at the time of contract formation. This fault is evident in the judgement of Mahoney JA in *PC Developments Pty Ltd v Revell*.[92] In his discussion of the principles to be applied in a case for claim of equitable relief against a possible injustice Mahoney JA held that it 'is for the court to consider whether the end result of all that has happened between the parties is such that the judicial conscience finds it unacceptable.'[93]

The dominant form of equitable supervision that Meagher JA envisions is dead. In fact, Meagher JA appears to accept this death and the superiority of the mechanical common law penalty test since 'the distinguished line of cases which supports ... [this] view makes its adoption inevitable'.[94]

Equity – in with the new

If equity is to have a 'supervisory jurisdiction' then it must work within the

86 Above n 20, 190 per Mason and Wilson JJ.
87 For example, 'The doctrine of estoppel by conduct is founded upon good conscience. Its rationale is not that it is right to save people from their own mistake. It is that it is right and expedient to save them from being victimised by other people': *Commonwealth v Verwayen* (1990) 64 ALJR 540 at 588 per Deane J. See also *Waltons Stores (Interstate) Ltd v Maher* (1988) 164 CLR 387 at 452 per Deane J.
88 Such as in *Commercial Bank of Australia v Amadio* (1983) 151 CLR 447.
89 Above n 20, 193-194.
90 *PC Developments Pty Ltd v Revell* (1991) 22 NSWLR 615 at 651.
91 Above n 6, 130.
92 Above n 90, 625.
93 Ibid. See also *Robert Stewart Ltd v Carapanayoti Ltd* [1962] 1 All ER 418 at 423 per McNair J.
94 Ibid.

framework of the liberalised genuine pre-estimate test. Thus, equity's proper role is in the consideration of whether the agreed damages are genuine pre-estimate.

It can be argued that the penalty doctrine asks whether an agreed damages assessment can be justified as a matter of conscience rather than relying on a strict arithmetic test. When damages are easily assessable then there will be no difficulty for a court to determine whether an agreed damages clause is 'out of all proportion ... [or] ... extravagant, exorbitant or unconscionable'.[95] However, when the damages are not easily calculable, such as when idiosyncratic perceptions are involved, then it is equity's reliance on conscience that determines whether the clause is penal. Such a view was adopted by Clarke JA in *PC Developments Pty Ltd v Revell*[96] in stating that a party must do more than show that a clause is penal in nature when using the penalty clause as a sword; the party has to show that it would be unconscionable for the vendors to retain the money or property.[97]

Since this reliance on conscience looks into the contract itself this raises the interesting question of whether this test is actually a good faith requirement. That is, the estimation of damages, while able to incorporate notions of damage strictly beyond the court's power of observation, must be made in good faith. Failure to make such an assessment of damages in good faith is an act of oppression and enforcement of the clause would be unconscionable.

Burton sets out the requirements that typify a breach of good faith:

> Bad faith performance occurs precisely when discretion is used to recapture opportunities foregone upon contracting when the discretion-exercising party refuses to pay the expected cost of performance. Good faith performance, in turn, occurs when a party's discretion is exercised for any purpose within the reasonable contemplation of the parties at the time of formation - to capture opportunities that were preserved upon entering the contract, interpreted objectively. The good faith performance doctrine therefore directs attention to the opportunities foregone by a discretion-exercising party at formation, and to that party's reasons for exercising discretion during performance.[98]

One can argue that the discretion that Burton refers to can be read to include the parties' discretions in claiming some forms of remote or idiosyncratic loss.

While it is easy to speculate that the intent behind the courts' conscience based test is really a good faith requirement, such speculation must be qualified by Rossiter's view that, 'The traditional judicial attitude is reflected in those judgements which refuse to examine the motives of a party in exercising a

95 Above n 20, 190.
96 Above n 90, 646.
97 Evans M, *Outline of Equity and Trusts* 2nd ed (1993 Butterworths, Sydney), at 159.
98 Burton S, 'Breach of Contract and the Common Law Duty to Perform in Good Faith' (1980-81) 94 *Harvard L Rev* 369 at 372-373.

contractual power.'[99] However, in accepting a more flexible approach to determining damages for the assessment of whether a clause is penal the courts are implicitly willing to delve into the parties' motives rather than relying upon strict contractual interpretation.

It is not too extreme to stretch the decision about a 'subject to finance' clause in *Meehan v Jones*[100] to the assessment of penalty clauses. In *Meehan* the court (particularly Mason J) stated the requirement that the party having the primary benefit of a 'subject to finance' clause did not have an unfettered discretion in deciding whether to obtain finance. Instead, the same party was under an obligation to act either honestly or honestly and reasonably.[101] While the notions of honesty sit well with the determination of a genuine pre-estimate of loss, the reasonableness element does not. For example, if a party holds idiosyncratic values which are incorporated into an agreed damages clause then loss flowing from breach will not seem reasonable to most people. However, it is this 'unreasonable' idiosyncratic belief that the party is specifically trying to ensure through the use of an agreed damages clause. Thus, if there is a good faith requirement akin to that expressed in *Meehan v Jones* it is more appropriate that it be to act honestly rather than honestly and reasonably. Certainly the requirement of honesty is consistent with a minimalist view of the ethical requirements for good faith in commercial negotiation.[102]

An argument based upon a good faith requirement when determining difficult or idiosyncratic agreed damages levels is not too far fetched as it appears consistent with the use of good faith in English law:

> Another typical function of the [good faith] principle which has emerged in the survey is its invocation in certain situations which demand fairness and reasonableness, and where, although a rule exists, it is difficult to establish its precise limits or where it is difficult to provide 'normal' rules.[103]

Is such a good faith explanation too neat? Possibly so, given the uncertainty surrounding the standing of good faith in Australia. Nevertheless it appears defensible. While some courts appear to be moving towards greater acceptance of a contractual obligation of good faith,[104] in *Service Station*

99 Above n 6, 144.

100 (1982) 149 CLR 537.

101 An alternative view of *Meehan v Jones* (and similar cases) is that 'these are cases where an express term is given business efficacy and saved from classification as an illusory promise by the addition of an implied term; these are not cases where an obligation of good faith in contractual performance is imposed by law': *Service Station Association Ltd v Berg Bennet and Associates Pty Ltd* (1993) 45 FCR 84 at 94 per Gummow J.

102 See, for example, the history of the United States Uniform Commercial Code provisions on good faith as recounted by Priestly JA in *Renard Constructions (ME) Pty Ltd v Minister for Public Works* (1992) 26 NSWLR 234 at 266-267.

103 O'Connor J, *Good Faith in English Law* (1990) Dartmouth, Aldershot, at 101. Footnotes omitted.

104 For example, in *Coal Cliff Collieries v Sijehama* (1991) 24 NSWLR 1 the New South Wales Court of Appeal (Kirby P, with who Waddell A - JA agreed; Handley JA in dissent) held that promises to negotiate in good faith are enforceable in appropriate circumstances. See also *The Commonwealth v Amann Aviation Pty Ltd* (1990) 22 ALR 601 per Davies J at 607 and Shepherd J at 616, and (1991) 104 ALR 1 per Mason CJ and Dawson J at 135.

Association Ltd v Berg Bennett and Associates Pty Ltd[105] Gummow J suggested it is an unresolved question whether a general contractural requirement of good faith is to be implied in Australia as a matter of law, and that there is no authority which binds the Federal Court to support a general contractual requirement of good faith.[106] Despite such a setback for advocates of a general good faith requirement, some courts remain inclined to impose a good faith requirement into certain contractual circumstances.[107] A residual good faith requirement – as set out by Clarke JA in *PC Developments Pty Ltd v Revell*[108] – may be one such circumstance. The requirement of good faith set out by Clarke JA is defeasible in nature; the presumption is of good faith unless the plaintiff can establish that it would be a breach of such good faith for the agreed damages clause to be enforced. This appears to fit with Priestly JA's view in *Renard Constructions Pty Ltd v Minister for Public Works*[109] that good faith is best considered as a defeasible concept.[110]

The genuine pre-estimate test appears simple in its application, its limits are difficult to establish when dealing with idiosyncratic values or difficult to measure damages. Thus, a subservient and minimalist good faith requirement appears to sit well with the penalty doctrine.

Reliance on a conscience-based test, even though apparently subservient to the genuine pre-estimate test, may create new problems. While many of the abolitionists advocate abolishing the penalty doctrine and replacing it with general notions of unconscionability,[111] other commentators point to problems that conscience based tests throw up:

> This reduction in litigation costs would, however, probably be partly (or even wholly) offset by increased litigation under alternative legal theories aimed at having the same effect as the rule against penalties. Since courts have attacked penalties for hundreds of years, judges may turn to fraud, unconscionability, or similar grounds to scrutinise stipulated damage clauses.[112]

Similarly, Goetz and Scott[113] argue that the abolition of the penalty doctrine could actually increase litigation costs as litigants would seek to use 'party sophistication ... [as] a relevant issue in determining the fairness of a

105 Above n 101.
106 Ibid at 92 and 98.
107 For example, see above n 101, 91-92 per Gummow J for a list of examples where the concept of good faith appears in Australian law.
108 Above n 90, 646.
109 (1992) 26 NSWLR 234.
110 Ibid at 266-267.
111 Ham, 'The Rule Against Penalties in Contract: An Economic Perspective' (1990) 17 *Melbourne University Law Review* 649; Goetz and Scott, 'Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach' (1977) 77 *Columbia Law Review* 554 at 594.
112 See Clarkson, Miller and Muris, 'Liquidated Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach' (1977) 77 *Columbia Law Review* 351 at 373.
113 Above n 50, 588.

stipulated damages provision'.[114] It can be argued that as long as a conscience based test lingers the temptation may be to seek to allow notions of fairness to over-ride the genuine pre-estimate test. Thus, as long as a conscience based test exists, in whatever form, freedom of contract is threatened.

Conclusion

There is little explicit evidence to suggest that law and economics has influenced the Australian approach to agreed damages clauses.[115] Although Mason and Wilson JJ in *AMEV-UDC v Austin* refer to Muir[116] there is little other evidence of specific economic consideration beyond general notions of ensuring contractual certainty.

All is not lost for law and economics proponents; it may not be a great concern that judges do not 'know' and enunciate (even through citation) economic theory in the explicit manner of economists:

> The fact that with few exceptions lawyers and judges are not self-consciously economic in their approach to law is a trivial objection to the positive economic analysis of the common law. The language of economics is a language designed for scholars and students, not for the people whose behaviour the economist studies. Poets do not use the vocabulary of literary critics; judges do not use the vocabulary of economists.[117]

However, the lack of clear economic reasoning must be a disappointment to both retentionists and abolitionists alike; the judiciary appears to be more concerned with issues of compensation rather than efficiency. Certainly maintaining expectancy is an integral element of efficient performance and breach, but the failure to explicitly consider wider notions of efficiency implies a less than full judicial understanding of efficient performance and breach.

With little explicit consideration of the abolitionist and retentionist positions it is difficult to determine which party would be more pleased with the recent judicial development of the penalty doctrine. Despite the continued existence of a penalty doctrine, abolitionists would be pleased with the weakening of the penalty doctrine's discretionary power and the judicial concern for maintaining expectancy. This answer, however, overlooks serious concerns that the abolitionists must hold.

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114 Ibid at 593.

115 This is in contrast to the United States. Harrison cites four works that have specifically influenced United States judicial opinion about agreed damages (further to simply being cited): see Harrison J, 'Trends and Traces: A Preliminary Evaluation of Economic Analysis in Contract Law' (1988) 1 *Annual Survey of American Law* 73 at 107-114; Kronman A and Posner R, *The Economics of Contract Law* (Little Brown and Company, Boston, 1979); Posner, *Economic Analysis of Law* 3rd ed (1986) Little Brown and Company, Boston.

116 Muir G, 'Stipulations for the Payment of Agreed Sums' (1985) 10 *Syd Law Rev* 503. While Muir is not explicitly a proponent of the law and economics school, Rossiter includes this article in his criticism of 'Posner and his apostles': Above n 6, 139-141.

117 Posner, Economic Analysis of Law (4th ed, 1992, Little Brown and Company, Boston) at p 255.

Ultimately, the debate between abolitionists and retentionists is not resolved, nor near resolution. To this extent the penalty doctrine exposes the difficulty inherent in the application of economic theory to real-world examples. At different times the arguments made by both parties appear valid. Thus, rather than focusing on compensation or simplistic reliance on maintaining certainty, it would be interesting, and quite possibly rewarding, to see courts more explicitly explore the parallel economic reasoning behind the penalty doctrine.