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## Penalty Clauses as Remedies: Exploring Comparative Approaches to Enforceability

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**PENALTY CLAUSES AS REMEDIES:  
EXPLORING COMPARATIVE APPROACHES TO  
ENFORCEABILITY**

*Jack Graves*<sup>\* \*\*</sup>

*Commercial agreements often provide for “fixed sums” payable upon a specified breach. The common law distinguishes between provisions for “liquidated damages” and “penalty” clauses, enforcing the former, while invalidating the latter as punitive. In contrast, such agreements are generally enforced in civil law jurisdictions, without any distinction between liquidated damages and penalties—though they may be reduced if excessive, even as penalties. In contrast, this same split between the civil and common law jurisdictions can be found in the treatment of specific relief, with the former presumptively granting such “ordinary” relief, subject to a narrowly cabined set of exceptions, and the latter granting such relief only under certain limited “extraordinary” circumstances.*

*In a recent article, I suggested that the validity of “fixed sums,” as “penalties,” was an issue not governed by the United Nations Convention on Contracts for the International Sale of Goods (the “CISG”) and, instead, left to otherwise applicable domestic law. In doing so, I pointed to the relationship under the civil law between the ordinary right to specific performance and the general enforceability of penalties, in arguing that the treatment of one under the CISG suggested a general principle informing the proper treatment of the other under that same body of law. Interestingly, however, Israeli law takes a unique combined approach to these two remedies: specific performances and fixed sums (or “agreed compensation” as termed under Israeli law).<sup>1</sup> Israeli law seemingly follows a civil law*

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\*\* Editor’s Note: The following article has been adapted with additional commentary and concepts from Jack Graves, *Penalty Clauses and the CISG*, 30 J.L. & COM. 153, 153 (2012).

<sup>1</sup> Yehuda Adar & Gabriela Shalev, *The Law of Remedies in a Mixed Jurisdiction: The Israeli Experience*, 23 TUL. EUR. & CIV. L.F. 111, 134 (2008).

*approach to specific performance, while following the common law approach to agreed compensation in the form of fixed sums.<sup>2</sup> This paper examines the “mixed” nature of the Israeli approach to remedies and then asks if this examination might shed any further light on the logic (or lack thereof) of the common law distinction between liquidated damages and penalties.*

## I. INTRODUCTION

Contracts often provide for payment of “fixed sums” upon a specified breach.<sup>3</sup> Such terms may serve a broad variety of purposes.<sup>4</sup> However, most such purposes will focus on one of three basic objectives: (1) good faith estimation of damages likely to be caused by the specified breach; (2) coercion of performance by requiring, in the event of non-performance, the payment of a fixed sum that exceeds any reasonable estimate of actual damages; or (3) limitation of damages by fixing a sum less than any reasonable estimate of actual damages.<sup>5</sup> This article will focus on the distinction between the first two objectives—the estimation of actual damages, as contrasted with coercion of performance through the threat of a penalty for non-performance. In the discussion that follows, and consistent with common practice,<sup>6</sup> I will use the term “liquidated damages” clause to refer to a “fixed sum” intended as a good faith estimate of actual damages, while I will use the term “penalty clause” to refer to a punitive “fixed sum” intended to deter breach beyond the effect provided by the standard monetary “expectation” remedy for breach.

Liquidated damages clauses in commercial agreements are generally enforceable in all legal systems.<sup>7</sup> In contrast, penalty clauses are generally enforceable in civil law systems,<sup>8</sup> but have his-

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<sup>2</sup> *Id.*

<sup>3</sup> *See, e.g.*, JOHN EDWARD MURRAY, JR., MURRAY ON CONTRACTS § 125(A) (2001).

<sup>4</sup> *See, e.g.*, E. ALLAN FARNSWORTH, CONTRACTS § 12.18 (4th ed. 2004).

<sup>5</sup> MURRAY JR., *supra* note 3.

<sup>6</sup> *See, e.g.*, MURRAY, JR., *supra* note 3, § 125(A)(1); FARNSWORTH, *supra* note 4 (discussing liquidated damages in terms of penalties and remedies).

<sup>7</sup> INGEBORG SCHWENZER AND PASCAL HACHEM, SCHLECHTRIEM & SCHWENZER: COMMENTARY ON THE UN CONVENTION ON THE INTERNATIONAL SALE OF GOODS (CISG) para. 44, at 93 (Ingeborg Schwenzler ed., 3d ed. 2010); Pascal Hachem, *Fixed Sums in CISG Contracts*, 13 VINDOBONA J. INT’L COM. L. & ARB. 217, 220 (2009) [hereinafter Hachem, *Fixed Sums*].

<sup>8</sup> Hachem, *Fixed Sums*, *supra* note 7, at 220 (explaining that while a penalty clause may be reduced, as “excessive” under most civil law regimes, such a reduction is very different

torically been deemed invalid under the common law based on their coercive nature and punitive effect when enforced.<sup>9</sup> This same split between the civil and common law jurisdictions can be found in the treatment of specific relief, with the former presumptively granting such relief, subject to a narrowly cabined set of exceptions, and the latter granting such relief only under certain “extraordinary” circumstances.<sup>10</sup> These two distinct doctrinal splits arguably focus on the same basic philosophical difference between the common and civil law approaches to the enforcement of a promise—the common law generally seeks to give effect to the economic value of the promise while the civil law generally seeks to give effect to the promise itself. Interestingly, however, Israeli law takes a unique combined approach to these two remedies: specific performances and fixed sums (or “agreed compensation” as termed under Israeli law)—seemingly following a civil law approach to the former and a common law approach to the latter.<sup>11</sup>

This article begins with a very brief comparison of the manner in which common and civil law systems treat penalty clauses and the remedy of specific performance.<sup>12</sup> It then examines the apparently “mixed” nature of the Israeli approach in addressing these two remedies and asks if this difference in approach might shed any further light on the logic (or lack thereof) of the common law distinction between liquidated damages and penalties.<sup>13</sup>

## II. COMPARATIVE LEGAL TREATMENT OF PENALTY CLAUSES AND THE REMEDY OF SPECIFIC PERFORMANCE

The treatment of penalty clauses is fundamentally different, as between civil and common law legal systems. A penalty clause is generally enforceable under the civil law, while it is not enforceable under the common law.<sup>14</sup> Moreover, the same theoretical underpin-

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from the common law approach to invalidating penalty clauses, which abhors any penalty).

<sup>9</sup> FARNSWORTH, *supra* note 4 (explaining the common law as limiting fixed sums to those that are “compensatory” in nature—in contrast, by implication, to those that are “punitive” in nature).

<sup>10</sup> Franco Ferrari, *What Sources of Law for Contracts for the International Sale of Goods? Why One Has to Look Beyond the CISG*, 25 INT’L REV. L. & ECON. 314, 337 (2005).

<sup>11</sup> Adar & Shalev, *supra* note 1.

<sup>12</sup> See discussion *infra* Part II.

<sup>13</sup> See discussion *infra* Part III.

<sup>14</sup> See discussion *infra* Part II-A.

nings of these different approaches to penalty clauses can also be found in the two legal systems' different approaches to the remedy of specific performance.<sup>15</sup>

### A. Penalty Clauses

The civil law generally enforces fixed sums, whether intended to approximate damages or to deter breach.<sup>16</sup> Thus, a fixed sum intended as a "penalty" will typically be enforced. While a court may adjust the amount of a "penalty" it considers excessive, the fact that the "penalty" tends to deter breach does not, itself, preclude enforcement.<sup>17</sup> The prominent issue is the amount of the penalty and whether that amount is deemed excessive.<sup>18</sup>

Like civil law, the common law also grants contracting parties substantial autonomy in defining their respective rights and obligations.<sup>19</sup> However, their autonomy in defining remedies for breach is subject to certain limits, including limits on "fixed sums" payable in the event of breach.<sup>20</sup> A sum fixing an amount or method of determining "liquidated damages" is enforceable, while a sum fixing a "penalty" intended to deter breach is void.<sup>21</sup>

In view of the fact that most civil law regimes provide some limits on the amount of a penalty clause, one might be tempted to suggest a similarity between the civil and common law approach in that each in some fashion restricts the parties' autonomy with respect to a contractually agreed upon fixed sum. However, the two systems take fundamentally different approaches to justifying such restrictions, thus exposing the difference in their basic underlying prin-

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<sup>15</sup> See discussion *infra* Part II-B.

<sup>16</sup> Pascal Hachem, *Agreed Sums in CISG Contracts*, 3 BELGRADE L. REV. 140, 141 (2011) [hereinafter Hachem, *Agreed Sums*].

<sup>17</sup> See *id.* at 141-42, 145-46 (discussing the history of civil law's broad acceptance of fixed sums).

<sup>18</sup> *Id.* at 142.

<sup>19</sup> See, e.g., U.C.C. § 2-301 (McKinney 1962) (defining the general obligation of buyers and sellers as simply to comport with the terms of the contract). This article does not purport to provide a complete survey of common law legal regimes or any nuanced differences among them in the treatment of "fixed sums." Instead, United States common law, as well as its reflection in UCC Article 2, is used here as exemplary of the common law approach to the issue.

<sup>20</sup> See, e.g., UCC §2-718(2)(3) (2011) (providing statutory limits on the parties' contractual rights to limit or exclude certain remedies).

<sup>21</sup> FARNSWORTH, *supra* note 4.

ciples.<sup>22</sup> Unlike the civil law, the common law abhors any penalty—irrespective of the amount.<sup>23</sup>

The parties to a contract may stipulate in advance to a specified amount or methodology for determining damages in the event of a specified breach. As long as the amount represents a reasonable effort to ascertain in advance or “liquidate” damages that might otherwise be uncertain or difficult to prove, the provision will be enforceable as “liquidated damages.”<sup>24</sup> Such clauses offer substantial utility in providing a remedy in the event of breach while retaining the basic common law focus on “compensatory” rather than “punitive” damages for breach of contract.<sup>25</sup> In contrast, a “penalty” clause requires payment of fixed amount that is inconsistent with this same basic approach.

A “penalty” clause goes beyond compensating the aggrieved party for its promissory loss and has the further effect of deterring breach and compelling performance.<sup>26</sup> This is known as the “*in terrorem*” effect of a penalty clause and is, in fact, the intent of such a clause.<sup>27</sup> This deterrent effect is inconsistent with the fundamental remedial approach of the common law focus on redressing breach through damages—but *not* compelling performance.<sup>28</sup> Moreover, it would be unjust to “punish” a party based on what is essentially a “strict liability” standard for breach of contract.<sup>29</sup> Common law damages are intended to be, in effect, neutral as between performance and payment of damages for non-performance.<sup>30</sup> This common law hos-

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<sup>22</sup> *Id.*

<sup>23</sup> *Id.*

<sup>24</sup> *Id.*

<sup>25</sup> *Id.*

<sup>26</sup> FARNSWORTH, *supra* note 4.

<sup>27</sup> *Id.*

<sup>28</sup> RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 149 (8th ed. 2011).

<sup>29</sup> XCO Int'l, Inc. v. Pacific Scientific Co., 369 F.3d 998, 1001-02 (7th Cir. 2004); Charles J. Goetz & Robert E. Scott, *Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach*, 77 COLUM. L. REV. 554, 560-61 (1977).

<sup>30</sup> See Goetz & Scott, *supra* note 29, at 558 (explaining the indifference between performance and payment of damages is often referred to as the “indifference principle”); see also Hachem, *Agreed Sums*, *supra* note 16, at 221. Hachem suggests that the value of a party’s right to specific performance must be accounted for in applying this principle, thereby justifying the use of a penalty intended to deter breach. However, this mixes the civil law right to such performance with a common law principle based on the damages as the normal remedy. The civil law right to performance and the right to enforce a penalty clause go hand-in-glove—just as the common law preference for damages and the invalidity of a penalty

tility towards penalty clauses originated in courts of equity, which by the end of the seventeenth century were no longer willing to enforce the historical “penal bond,”<sup>31</sup> sending the parties instead to courts of law for a determination of actual monetary damages.<sup>32</sup> Today, the common law renders a penalty clause generally unenforceable, and, in the case of United States law governing the sale of goods, deems such a penalty “void.”<sup>33</sup>

Notably, the parties to a contract may accomplish some of the same objectives as those they might seek to accomplish through a penalty clause by framing the fixed sum due as a contractual performance obligation instead of a remedy for breach. For example, a bonus that gives significant incentives for performance would likely be fully enforceable, whereas a penalty for non-performance would not. A fixed sum may also fairly be characterized as one of two “alternative performances,” in which case the promised contractual obligation to pay the amount due is likely to be enforced.<sup>34</sup>

One might be tempted to point to these examples in suggesting that the common law treatment of fixed sums is more about form than substance. However, there is a critical difference between the above contractual promise to pay money as a performance obligation and a “penalty” clause triggered by a breach. The former involves the parties’ rights and obligations, while the latter involves a remedy for breach sought from a court or arbitral tribunal after the parties’ agreement has run aground on the rocks of an intractable dispute. When parties negotiate a contract, they typically focus far more on their performance “rights and obligations” than on “remedies” in the event of breach. Parties expect to perform—not to breach—so their exercise of autonomy with respect to the former arguably deserves greater deference than the latter.

The common law approach to penalties has unquestionably

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clause.

<sup>31</sup> See generally WILLIAM SHAKESPEARE, *THE MERCHANT OF VENICE* (Barbara A. Mowat & Paul Werstine eds., Wash. Square Press 1992) (illustrating possibly the most famous “penal bond” was that of Antonio’s promise of a “pound of flesh” to Shylock in the event of default on his promise to repay 300 Ducats); see also 1 STEWART MACAULEY, ET AL., *CONTRACTS: LAW IN ACTION, THE INTRODUCTORY COURSE* 107 (3d ed. 2010) (discussing the “pound of flesh” and *The Merchant of Venice* in connection with penalty clauses).

<sup>32</sup> MURRAY, JR., *supra* note 3, § 125(A)(1); FARNSWORTH, *supra* note 4.

<sup>33</sup> U.C.C. § 2-718(1) (2011).

<sup>34</sup> See JOSEPH M. PERILLO, *CALAMARI AND PERILLO ON CONTRACTS* § 14.34 (6th ed. 2009).

been subject to substantial criticism by both courts<sup>35</sup> and commentators.<sup>36</sup> However, its continued application by the courts—in spite of such criticism—also proves its continuing vitality as domestic United States law.<sup>37</sup> The most common modern justification for the rule is based on the theory of “efficient breach.” In effect, society as a whole may be better served by a breach. If so, as long as the aggrieved party receives monetary damages compensating for its expectation loss, breach will be more efficient than performance.<sup>38</sup>

Critics argue that the “efficient breach” theory is flawed, both as a matter of business reality and economic theory. Contrary to the traditional theory of “efficient breach,” a penalty clause deterring breach may actually be more efficient, because this will simply lead the parties to negotiate and share the economic fruits of the contemplated breach.<sup>39</sup> However, this ignores the very real challenges inherent in negotiating in the context of what is essentially a bilateral monopoly,<sup>40</sup> as well as the potential economic interests of third parties in an efficient breach.

Critics of the common law approach also often argue in favor of the “utility” of penalty clauses by pointing to various forms of damages that are difficult to calculate or prove.<sup>41</sup> However, these arguments fail to recognize that a true “liquidated damages” provision addresses the same issue and is fully enforceable, as such. One of the primary purposes of a “liquidated damages” clause is to provide for damages that are difficult to calculate or prove. In contrast, a true “penalty” clause is intended to deter a breach, rather than remedy such a breach.

The above analysis is exemplary only and is not intended to be exhaustive or to suggest that the common law approach is neces-

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<sup>35</sup> *XCO Int'l, Inc.*, 369 F.3d at 1001-02; *Lake River Corp. v. Carborundum Co.*, 769 F.2d 1284, 1288-89 (7th Cir. 1985).

<sup>36</sup> See Goetz & Scott, *supra* note 29; Kenneth W. Clarkson, et al., *Liquidated Damages v. Penalties: Sense or Nonsense*, 1978 WIS. L. REV. 351 (1978).

<sup>37</sup> See, e.g., *XCO Int'l, Inc.*, 369 F.3d at 1002-03; *Lake River Corp.*, 769 F.2d at 1289 (noting the departures from this standard approach in certain areas, such as insurance law); Hachem, *Agreed Sums*, *supra* note 16, at 147 (explaining that these departures are *sui generis* and typically involve what is, essentially, a tort, such as bad faith breach of an insurance contract).

<sup>38</sup> *XCO Int'l, Inc.*, 369 F.3d at 1001; see POSNER, *supra* note 28 (for a more thorough analysis of the theory of an “efficient breach”).

<sup>39</sup> See Goetz & Scott, *supra* note 29, at 567-68.

<sup>40</sup> POSNER, *supra* note 28, at 78.

<sup>41</sup> *Id.* at 160.



sarily superior to that of the civil law. In fact, there is much to commend each. The two key points, for purposes of this article, are that: (1) the common law will not enforce a “penalty” clause, as such, and that the reasons underlying this approach are reasonably defensible and not wholly irrational; and (2) the civil law will, in contrast, enforce a “penalty clause.”

### B. The Remedy of Specific Performance

The difference between the civil and common law treatment of penalty clauses is mirrored in the treatment of performance-based remedies in the two legal systems. The civil law treats specific performance as the ordinary remedy for breach, while the common law treats specific performance as an extraordinary remedy.<sup>42</sup> The ordinary civil law remedy focuses on the actual promises of the parties. Subject only to a narrow set of exceptions, a party to a contract governed by civil law will have an ordinary right to specific enforcement of its contracting partner’s actual promises.<sup>43</sup> In contrast, a party to a contract governed by the common law will ordinarily be entitled only to a “substitutional” remedy of money damages, absent a showing of extraordinary circumstances justifying specific relief.<sup>44</sup>

The common law approach to specific performance is based on the same basic doctrinal underpinnings as its approach to penalty clauses—the ordinary common law of remedies is neutral, as between performance and payment of damages in compensation for non-performance.<sup>45</sup> As in the case of penalty clauses, the common law’s treatment of performance-based remedies reflects a general “economic” approach to remedies.<sup>46</sup> In contrast, the civil law focuses on the “promissory” nature of a contract—whether enforcing a promise to pay a fixed sum in the event of a defined breach (even if it amounts to a “penalty”) or any other contractual promise.<sup>47</sup>

If a party refuses to perform a contractual promise, a civil law

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<sup>42</sup> See Ferrari, *supra* note 10, at 336-37.

<sup>43</sup> MURRAY, JR., *supra* note 3, § 127(A).

<sup>44</sup> *Id.*

<sup>45</sup> *Id.*

<sup>46</sup> See *XCO Int’l, Inc.*, 369 F.3d at 1001 (explaining that the doctrine of efficient breach drives not only the common law approach to penalties, but also the common law treatment of damages, as the normal remedy, and specific relief, as extraordinary).

<sup>47</sup> See MURRAY, JR., *supra* note 3, § 127 (noting the civil law’s inclination to compel the contract promise be fulfilled).

court will typically compel such performance.<sup>48</sup> Thus, it seems entirely consistent to allow one of the parties to “compel” the other’s performance through the use of a “penalty” clause. In contrast, a common law court will not typically compel a party’s actual performance, so it would seem inconsistent to give either of the parties such a right.<sup>49</sup> Admittedly, a common law court may, under proper circumstances, order specific performance, as an extraordinary remedy.<sup>50</sup> However, a discretionary and extraordinary award of specific performance by a court of equity is far different from the grant of power to one of the parties to compel performance through a penalty clause.

In summary, we can see that the treatment of “penalty” clauses and the remedy of specific performance each rely on a single set of core principles, and the differences between their “linked” or related treatment in civil and common law systems arise from differing core contract principles in each of these systems. Each of these relationships was expressly recognized in Secretariat Commentary to the CISG.<sup>51</sup> Thus, we would typically expect any given legal system to (1) enforce “penalty” clauses and treat “performance” as the ordinary remedy for breach; or (2) refuse to enforce “penalty” clauses and treat “performance” as an extraordinary remedy—but not to mix the two.<sup>52</sup> This leads us to an examination of Israeli contract law, which does exactly the latter.

### III. ISRAELI LAW AS A “MIXED” APPROACH TO REMEDIES

Israel’s legal system reflects a “mix” of common and civil law principles.<sup>53</sup> However, one might reasonably expect Israeli law to

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<sup>48</sup> *Id.*

<sup>49</sup> *See id.* (stating that “money damages is the normal common law remedy”).

<sup>50</sup> *Id.*

<sup>51</sup> *See* GLOBAL SALES LAW, <http://www.globalsaleslaw.org/index.cfm?pageID=644#Article%2046> (last visited Feb. 10, 2013) (recognizing the Secretariat Commentary to the CISG in art. 46, paras. 9-10).

<sup>52</sup> *See* Ferrari, *supra* note 10, at 337 (recognizing that the decision whether or not to enforce “penalty” clauses, especially in solving disputes governed by the CISG, specifically Article 28, would depend on the law in the court’s jurisdiction because, according to the CISG, if “one party is entitled to require performance of any obligation by the other party, a court is not bound to enter a judgement [sic] for specific performance unless the court would do so under its own law in respect of similar contracts of sale not governed by this Convention”) (internal quotation marks omitted) (quoting CISG, art. 28).

<sup>53</sup> Adar & Shalev, *supra* note 1; Gabriela Shalev, *Law of Contract, in ISRAELI BUSINESS LAW: AN ESSENTIAL GUIDE* 25, 25-26 (Alon Kaplan ed., 1996) [hereinafter Shalev, *Law of*

follow either a common or civil law approach to both penalty clauses and the remedy of specific performance, in view of the similar principles that drive both. In this article, I note that Israeli law in fact takes differing approaches to these two issues,<sup>54</sup> and then suggest that these two differing approaches may be reasonably reconciled and that this reconciliation may shed additional light on the common law's traditional disdain for penalties.<sup>55</sup> Having suggested a consistent rationale for this "mixed" approach to the two remedies at issue, I then illustrate the point by reference to Shakespeare's *The Merchant of Venice*.<sup>56</sup>

### A. Israeli Law

When one party breaches a contract obligation, the aggrieved party will ordinarily be entitled to require actual performance of the contract.<sup>57</sup> This right to performance is limited only by four specific statutory exceptions in cases of: (1) impossibility of performance; (2) personal work or service; (3) a requirement of excessive supervision of performance; or (4) circumstances in which a requirement of performance would be unjust. The ordinary remedial presumption is, therefore, one in which a court will require actual performance at the request of an aggrieved contracting party. This approach to the basic remedy of performance is fully consistent with civil law doctrine.<sup>58</sup>

Unlike the common law, the civil law does not typically draw a distinction between contract rights and remedies for breach of contract.<sup>59</sup> Instead, a civil law "remedy" is simply another contract right or entitlement.<sup>60</sup> Under this view, the court merely enforces the parties' basic entitlements, instead of seeking to remedy a breach or "right a wrong" of some sort.<sup>61</sup> Importantly, however, the court re-

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*Contract*].

<sup>54</sup> See discussion *infra* Part III-1; see Adar & Shalev, *supra* note 1, at 111 (noting the same mixed approach to the two remedies).

<sup>55</sup> See discussion *infra* Part III-B.

<sup>56</sup> See discussion *infra* Part III-C.

<sup>57</sup> *Contracts (Remedies for Breach of Contract) Law, 5731—1970 Dated 27th March 1971*, in 1 LOUIS GARB, *BUSINESS LAWS OF ISRAEL* 1.5-1, 1.5-1-1.5-3 (Louis Garb, et al., eds., 2d ed. 2002) [hereinafter GARB]; see also Adar & Shalev, *supra* note 1, at 140; Shalev, *Law of Contract*, *supra* note 53, at 35.

<sup>58</sup> Adar & Shalev, *supra* note 1, at 134; Shalev, *Law of Contract*, *supra* note 53, at 35.

<sup>59</sup> Adar & Shalev, *supra* note 1, at 113.

<sup>60</sup> *Id.* at 114.

<sup>61</sup> *Id.* at 122.

tains a limited review function based on the four enunciated statutory exceptions.<sup>62</sup>

In view of its granting to the parties of an “ordinary” right to a remedy of “performance,” one might reasonably expect Israeli law similarly to enforce the parties’ attempt to ensure performance through the use of a penalty clause. However, Israeli law takes a different path, following the general common law approach in eschewing “penalties.”<sup>63</sup>

When an aggrieved party seeks monetary damages, Israeli law applies a “compensatory” approach much like that of the common law.<sup>64</sup> The aggrieved party is entitled to “compensation for the damage caused to him by the breach and its consequences and which the person in breach foresaw or should have foreseen, at the time the contract was made, as a probable consequence of the breach.”<sup>65</sup> Such “compensation” may be agreed upon in advance (“agreed compensation”), in which case the aggrieved party shall be entitled to such amount, without proof of actual damages. A court may, however, “reduce the compensation if it finds that it was fixed without any reasonable relation to the damage which could be foreseen, at the time the contract was made, as a probable consequence of the breach.”<sup>66</sup>

Thus, a court will not enforce “agreed compensation” if it is not reasonably related to the actual amount of damages, as such damages would be calculated under the statute.<sup>67</sup> In other words, a court will enforce an amount reasonably intended to “liquidate” damages in advance, but will not enforce an amount that is intended as a “penalty.”<sup>68</sup> This approach to “agreed compensation,” generally, and penalties, specifically, is fully consistent with common law doctrine.<sup>69</sup>

So, is this “mixed” civil and common law approach to these two issues inconsistent, or can such a “mix” be reasonably reconciled? The most obvious distinction between “performance,” as a

<sup>62</sup> See discussion *infra* Part III-B.

<sup>63</sup> Adar & Shalev, *supra* note 1, at 133-34.

<sup>64</sup> *Id.*

<sup>65</sup> GARB, *supra* note 57, para. 10, at 1.5-3.

<sup>66</sup> *Id.* para. 15(a), at 1.5-4. Again, it is important to distinguish between a rule providing for a reduction in a fixed sum that is excessive, as damages (the Israeli approach), and a rule providing for a reduction in a fixed sum that is excessive, even as a penalty (the civil law approach).

<sup>67</sup> See PERILLO, *supra* note 34, §14.31.

<sup>68</sup> *Id.* §14.31(c); GARB, *supra* note 57.

<sup>69</sup> Adar & Shalev, *supra* note 1, at 133-34.

remedy, and the use of a penalty to require that same performance is the unique and important role of the court in the former. However, there is arguably another crucial difference in the manner in which the parties view expected performance obligations, as distinguished from remedies for unanticipated breaches.

### B. A Distinction with a Difference

Modern contract law grants sophisticated parties almost unlimited autonomy in crafting their basic rights and obligations under a contract.<sup>70</sup> However, the law is far more restrictive when it comes to remedies, and there is a sound and obvious basis for the distinction. The parties' voluntary performance of their respective contractual obligations does not typically require the overt coercion of the state. In contrast, remedies do ultimately rely on the enforcement power of the state, and this power is often limited. The Israeli law governing specific performance is a perfect illustration of such limits.

While an aggrieved party is "ordinarily" entitled to "performance," the court may limit that right under the Israeli statute when the circumstances suggest that requiring performance is fundamentally unreasonable or unjust.<sup>71</sup> However, a party faced with a contract provision mandating the payment of a "penalty" for non-performance must perform or pay the penalty—assuming it is to be enforced.<sup>72</sup> The party's dilemma of "performance or penalty" will not necessarily be mitigated in the same way a court will exercise its judgment in deciding whether or not to award a remedy of performance. Thus, the Israeli statute regarding "agreed sums" can reasonably be explained as limiting the parties to agreement on truly compensatory amounts and reserving to the state the power to "compel" performance.

However, there is another, somewhat more subtle, distinction that may also serve to justify the common law approach to penalties—even in a system in which performance is the "ordinary" remedy for breach. While most parties give significant consideration to their contractual promises before undertaking those promises, far less consideration is typically given to remedies to be invoked only in the event of breach. At the time of contract, few parties—even sophisti-

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<sup>70</sup> See Michael Van Alstine, *Consensus, Dissensus, and Contractual Obligation Through the Prism of Uniform International Sales Law*, 37 VA. J. INT'L L. 1, 36-41 (1996).

<sup>71</sup> See *infra* Part III-A.

<sup>72</sup> Adar & Shalev, *supra* note 1, at 133.

cated parties—ever believe they will breach.

### C. *The Merchant of Venice* Revisited

An excellent illustration of the above-described phenomenon can be found in Act 1, Scene III, of Shakespeare's *The Merchant of Venice*.<sup>73</sup> The scene opens with Shylock, a sophisticated lender, negotiating a loan with Antonio, a sophisticated merchant.<sup>74</sup> When Shylock proposes a “pound of flesh,” as a bond in the event of Antonio's default (a classic “penalty” clause), Bassanio (the ultimate beneficiary of the loan) immediately protests “you shall not seal such a bond for me . . . .”<sup>75</sup> However, Antonio is undeterred by the onerous penalty, explaining:

Why, fear not, man, I will not forfeit it!  
Within these two months—that's a month before  
This bond expires—I do expect return  
Of thrice three times the value of this bond.<sup>76</sup>

It is simply beyond Antonio's contemplation that he will default, so the punitive bond is ignored.<sup>77</sup> When Antonio seals the bond, he does so in the firm and unwavering certainty that it will never come due. Of course, the unthinkable transpires—all of Antonio's ships are lost, and he fails to repay the loan when due.<sup>78</sup> Did Antonio actually consent to give Shylock a pound of flesh, or did Antonio simply assume that provision out of the contemplated bargain? I would suggest that the latter is far more reflective of Antonio's conscious intent. I am not suggesting that contract law should abandon generally accepted rules of interpretation focusing on objective manifestations of intent when parties, in good faith, disagree over the content of their agreement. However, I would suggest that, in the vast majority of contracts, neither party expects to breach its obligations. Thus, when thinking about enforcing the parties' actual bargain-in-fact, it is quite objectively reasonable to distinguish between affirmative promises of performance and advance agreements regarding remedies for breach.

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<sup>73</sup> SHAKESPEARE, *supra* note 38, at act I, sc. III.

<sup>74</sup> *Id.* at 31.

<sup>75</sup> *Id.* at 37.

<sup>76</sup> *Id.*

<sup>77</sup> *Id.* at 39.

<sup>78</sup> SHAKESPEARE, *supra* note 38, at 99-103.

**IV. CONCLUSION**

All legal systems will enforce contractual rights and obligations to which parties effectively consent, even if the parties fail to read the documents in which they are found. All legal systems will also enforce a genuine estimate of damages in the event of breach—even if the contracting parties did not expect such a breach—because a genuine estimate of expectation damages serves as a functional equivalent of the promised performance. However, a penalty is arguably far beyond the parties' actual expectations at the time of contracting. As such, a reasonable case can be made that this distinction justifies the common law difference in treatment between “liquidated damages” clauses and “penalty” clauses, as remedies.