Civil Contract Law and Economic Reasoning
An Unlikely Pair?

Aristides N. Hatzis
University of Athens

Abstract
Is there any economic reasoning behind Civil law as there supposedly is behind Common law? Is Civil law efficient or at least as efficient as Common law? To answer this question, I have decided to use contract law as the object of comparative analysis. In the areas where there is a significant difference between Common and Civil law, which law is more efficient? Which legal family is closer to economic reasoning? In this paper, I am going to explore these questions. First of all, I am going to present my hypothesis that Civil law (or at least Civil contract law) is more efficient than Common law. In order to test this hypothesis, I will be discussing two major issues in the economics of contract law: efficient breach and penalty clauses. In these two areas, economists have criticized Common law, characterizing its institutions as inefficient. I will go over the criticisms and try to show that the opposite is true: that in fact Civil law is more efficient than Common law in these two areas. Finally, I am going to discuss briefly why economic analysis of law is still useful for Civil law and why it can be instrumental for the interpretation of contracts by lawyers.

JEL Classification: K12

Keywords: Economics of Contract Law; Civil Law and Common Law; Comparative law and economics; Efficiency of Common Law hypothesis; Efficient Breach; Penalty Clauses

Forthcoming
The Architecture of European Codes & Contract Law
Stefan Grundmann, editor
If the soil of Europe is so much less fertile for economic analysis than that of the United States, how is one to explain the rapid growth of the field in Europe? (Posner 1997: 5)

It is a well-known fact that “law & economics”, i.e. “economic analysis of law” is an American product. Its founding fathers are all American, working in American law schools, and writing about American law in American law reviews. Therefore, it is hardly surprising to find an abundance of literature in American law and economics and in Common law and economics in general. At the same time, it can prove to be extremely difficult to find papers on European themes in the established journals of the field.¹

However, there is a growing number of European scholars working on law & economics since at least the early eighties and a growing number of younger scholars for the past 10 years. Even though the number of their publications is not analogous to their number (which is due in great extent to the aforementioned “jurisdictional” bias in the major journals), one could safely say that there is a sizable corpus of law & economics literature written by European scholars. Nevertheless, again, the majority of these papers do not use the economic tools to treat specific European institutions and legal systems, but they either discuss theoretical problems or they treat institutions as generic. In addition, the papers discussing European themes choose either to analyze European Union law or areas of economic law, where Euro-

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¹ I am referring to the two leading journals in the field: the Journal of Law & Economics (founded in 1958 by Aaron Director) and the Journal of Legal Studies (founded in 1972 by Richard Posner) both published by the University of Chicago Law School. See also the Journal of Law, Economics, & Organization, the Supreme Court Economic Review and the American Law & Economics Review. The International Review of Law & Economics and the European Journal of Law & Economics are more hospitable to papers written by European authors.

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* Lecturer of Philosophy of Law & Theory of Institutions, University of Athens, Department of Philosophy & History of Science (L.L.B. 1989, L.L.M. 1993, Aristotle University of Thessaloniki, Faculty of Law; L.L.M. 1994, J.S.D. 1999, University of Chicago Law School). Earlier versions of this paper have been presented in the European School on New Institutional Economics (Cargèse-Corsica, May 2004), the conference on the “Architecture of European Codes and Contract Law” organized by the Society of European Contract Law (Vienna, June 2004), and the workshop on the “Co-evolution on Law & Economics” organized by the European Association of Evolutionary Political Economy (Rethymno-Crete, October 2004) and in a lecture at the University of Siena (April 2005). I am indebted for helpful discussions and comments to Eric Brousseau, Bruce Chapman, Bruno Deffains, Stefan Grundmann, Antonio Nicita, Ugo Pagano, Aspasia Tsoussis, Richard Zerbe and the participants in my lectures and workshop presentations. For comments, please send me an email: ahatzis@phs.uoa.gr.
pean legal theory follows Anglo-Saxon law closely (e.g. competition law, corporate law, securities law, etc.).

As a result, there are very few studies to discuss contracts, torts, property and unjust enrichment, i.e. the problems which are dealt by Common law in the U.S.A. and by Civil Codes in continental Europe. These four areas constitute the basis of private law and they are the areas where American law & economics scholars have shifted their attention almost exclusively for many years. It is characteristic that even today most American law & economics textbooks cover only these fields. The reason is that they have elaborated these fields to exhaustion and they are more than illustrative of what law & economics can offer to classical legal theory. Unfortunately, the respective published work in continental Europe is minimal. Moreover, comparative law and economics is still at a nascent stage, despite some important contributions to the field.

And yet, the underdevelopment of the economic analysis of Civil law should not be taken to signify that Civil law is not amenable to economic analysis or that it is inefficient, or at least less efficient than Common law. Actually, as I am going to argue, rather the opposite is true, especially in what concerns Civil contract law. In a series of papers, I have attempted to show that Civil contract law is a fertile ground for economic analysis and, what is more, is more efficient than Common contract law.

In this paper I will try to present my work in the area, to organize my findings and to suggest directions for future research. In the first part of the paper I will briefly present an economic model of Civil contract law, and also try to clarify some common misconceptions. In the second part of the paper, I am going to present some findings from my research in the area which are surely interesting even though controversial and counterintuitive. My basic point is that Civil law is not only friendlier, but also more amenable to economic analysis than Common law. In the third and fourth part of the paper, I will use efficient breach and penalty clauses as examples, supporting my thesis on the efficiency of Civil law, but at the same time

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2 See e.g. the papers published in the IRLE and the EJLE.

3 With the possible addition of criminal law. See e.g. Polinsky (2003), Cooter & Ulen (2004) and Shavell (2004).

4 But see Mattei (1997), Hatzis (2005a) and a new journal that will be launched in 2006 under the title: Civil Law & Economics Review – and will specialize in the economics of Civil law.

5 My work in the area can be found in Hatzis (1999, 2000, 2003a, 2003b and 2005b). I borrow extensively from some of the above papers. However, one should refer to them for a more detailed and nuanced treatment of the particular issues and arguments.
demonstrating how helpful economic analysis can be in the interpretation and construction of a Civil code.

I. An Economic Theory of Civil Contract Law

The most common misconception about economic analysis of law is that it glorifies money and material wealth. Supposedly, economists are only interested in maximizing wealth, without caring about the weak parties in transactions and with no concern for distributive effects. I believe that this picture is unfair, but I will not be discussing it in this paper. My concern in this section is to show that the concept of economic efficiency as applied to contracts can be compatible with the aims of Civil contract law. Despite the critique that economists are indifferent to the asymmetries in a contractual relationship, I will demonstrate that economists share the lawyers’ concerns.

The following passage by Milton Friedman is characteristic:

*The possibility of coordination through voluntary cooperation rests on the elementary – yet frequently denied – proposition that both parties to an economic transaction benefit from it, provided the transaction is bilaterally voluntary and informed.* Milton Friedman (1962: 13).

Let’s see what the above statement entails. In a contract, two rational actors promise to limit their future actions with the objective of deriving, from the present or future actions of the other party, a benefit that will be greater than the cost of restricting their actions. The presumption of economic analysis is that the contracting parties are rational, in that they always devise the most effective way to satisfy their preferences. In a contract, there is the initial assumption that the parties can efficiently regulate the contractual relationship they have engaged in and that they can solve all the potential problems stemming from the development of this relationship. Thus, the role of contract law is primarily to enforce people's promises, since these promises are by default (initially) value-enhancing and the purpose of the law is, in this instance, to encourage and facilitate the maximization of the well-being of the members of society by enforcing the wishes of contracting parties, as they are expressed in their agreements recognized as contracts.

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6 The parties will arrive at a Pareto optimal point after the performance of the contract and only then will the utility of the parties increase. However, this does not necessarily mean that the increase in utility will be distributed equally.
However, the fact that the parties decide for themselves what will be the benefit and what will be the cost of their future actions does not imply that they will always and necessarily make the right decisions. Even though it is widely accepted that the parties know best where their interests lie, it is also true that the parties can make mistakes, due to imperfect information and/or uncertainty about the future. There is a chance that (at least) one of them will make a miscalculation of the cost or the benefit, based on inaccurate information. Another potential and more common problem is the likelihood of a change in circumstances that will overturn the previous calculation of costs and benefits and will create a new situation which is, sometimes, totally different from the one the parties took as a given when constructing their relationship. Yet another problem, added on to those of imperfect information and “unforeseen contingencies”, is the opportunistic behavior of one of the parties, which is also a result of the sequential character of the performance and is pertinent to the problem of unforeseen contingencies due to asymmetric information.

Let me now turn to the relation between economic analysis and contract law, in order to determine how the former can help the latter solve the problems we have pointed to. Thus, I will examine the problems of contract law as economic problems, given that contracts constitute the cornerstone of any market economy.

In a perfect world of perfect competition, a contract could be perfect. A perfect contract is “a promise that, if enforceable, is ideally suited to achieving the ends of the promisor and the promisee” (Cooter & Ulen 1988: 230). In such a “complete contingent contract”,

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7 “The desirable effects from exchange all derive from the fact that each person receives, by subjective valuation, goods and services that are more valuable than those which are surrendered.” (Epstein 1995: 694 and also 701). See also Stephen (1988: 155 and especially 157: “[C]ontract law can be seen as ensuring that the optimal number of contracts is entered into.”) and Kronman & Posner (1979: 1-2).

8 The parties tend not to specify terms for low probability events, because the expected cost from this exclusion will be minimal, whereas the cost of including the terms is borne with certainty.

9 See Muris (1981) and Trebilcock (1993: 16). In conditions of perfect competition, opportunism would be extremely expensive given the full information and the consequent effects in reputation (“[b]ecause [market transactions] are repetitive, they usually make deceit and nonfulfilment of promises unprofitable”, Stigler 1982: 22. However, a contract modification is not always the result of opportunism. As relational contract theory (and more generally the theory of the firm) have shown, on many occasions the parties consider that a modification of the initial terms of their contract will be mutually beneficial or at least will be a better alternative than one ensuing from judicial intervention.

10 Indeed, the temporal element is an essential part of the definition of contract. See Kronman & Posner (1979: 3).

11 See esp. Craswell (2000), for a description of such an environment and a non-technical explanation of why, in a perfect market, only the efficient clauses survive.

12 In this section, we rely extensively on the model that is presented by Robert Cooter and Thomas Ulen in the first edition of their introductory book (see Cooter & Ulen 1988: 229-242) as the “economic theory of contract”, with some minor modifications. Cooter and Ulen’s summarization of the work of legal and economic scholars
every possible contingency would be foreseen and regulated by the parties. In this ideal world of perfect information and competition, opportunism would wane, given the existence of reputational effects (since information is costless) and the possibility of private sanctions. In such a utopia, the only function of contract law would be the enforcement of contracts – but even this would be redundant since market forces would assure contractual performance – and any intervention by the state would be inefficient.\(^\text{13}\)

Given that actual markets are merely the “reflection” of the idea of perfect markets with perfect competition and perfect (and thus symmetric) information, we should cope with the fact that imperfect information entails imperfect contracts. Nevertheless, in a basically free market economy where the distance between the theoretical concept of perfect competition and the reality of real markets is not so great, there is a good chance that many of the contracts will be nearly perfect, i.e. that they will serve the intentions of the parties adequately.\(^\text{14}\)

The fact that the great majority of contracts are performed without any significant problems constitutes empirical proof of this hypothesis.

Nonetheless, some “incomplete” contracts end up in court. Apparently, these are the contracts that heavily suffer from the “imperfection” of the market; consequently, contract law must deal with the problems stemming from this imperfection.\(^\text{15}\) The gravest circumstances of a “malfunctioning” market are “market failures”, where the distance between imperfect and perfect competition is so great as to create serious problems in many aspects of economic life and, in our case, in the formation or performance of contracts.

What is the function of contract law under such unfortunate circumstances? It is again to help the parties achieve their ends, but as they would have formulated them had the market been perfect. The only thing courts have to do is to mimic the (perfect) market,\(^\text{16}\) by restructuring contracts in a way that the parties would have done if there were no market failures.

\(^\text{13}\) See e.g. the famous remarks by Sir George Jessel in \textit{Printing and Numerical Registering Co. v. Sampson}, L.R. 19 Eq. 462, 465 (1875).

\(^\text{14}\) Or, rather, slightly imperfect (or imperfect in respects of slight significance). “No system has to be perfect to survive” (Epstein 1997: 3).

\(^\text{15}\) I consider a contract clause to be imperfect, i.e. inefficient, when “the harm it inflicts on buyers is greater than the savings it creates for sellers.” (Craswell 2000: 85).

\(^\text{16}\) See generally Posner (2003: 251) for the very useful distinction between “settings in which the cost of voluntary transactions is low” and “settings in which the cost of allocating resources by voluntary transactions is prohibitively high, making the market an infeasible method of allocating resources.”
There are six conditions that must be met in order for the market (and consequently for the contract) to be perfect:\(^\text{17}\)

<table>
<thead>
<tr>
<th>Condition</th>
<th>Description</th>
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<tbody>
<tr>
<td>(a) <strong>Rational Agents.</strong> Decisionmakers must have stable (i.e. rational) preferences. Their behavior must be rational(^\text{18}) and not random or irrational and they must try to maximize their utility given the constraints, by finding the best feasible outcome.</td>
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<tr>
<td>(b) <strong>Unconstrained Choice.</strong> The parties must be constrained only by the factor of scarcity (in their income, time, energy, consumer demand, technology, etc.) in the materialization of their preferences (but see Trebilcock 1993: 79-84). Their choice must be free and not subject to any other kind of restriction by private parties (e.g. threat) or by the state (e.g. regulation).</td>
<td></td>
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<tr>
<td>(c) <strong>Absence of Transaction Costs.</strong> The cost of engaging in any transaction should be minor for the parties. Problems arise from an absence of or an inefficiently low amount of bargaining because of high transaction costs.</td>
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<tr>
<td>(d) <strong>Absence of Externalities.</strong> The contract must not have negative third party effects. The cost of the transaction in its entirety must be borne by the parties and not by any other third party that has nothing to do with the contract.</td>
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<tr>
<td>(e) <strong>Perfect Information.</strong> The parties must be fully informed as to the nature and consequences of their choices. This does not mean that there should be no (primary) uncertainty as to future events, but that there should be no severe informational asymmetries or symmetric informational imperfections, distorting the choice of either party.</td>
<td></td>
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<tr>
<td>(f) <strong>Perfect Competition.</strong> There must be enough potential contractors, e.g. many buyers and many sellers (that is, no monopolies, monopsonies or oligopolies). None of the parties should have great market power in the particular market and use it to extract monopoly rents. More accurately, the party that has the market power should not exploit it to his/her favor, thus making the bargain overly one-sided.</td>
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\(^{17}\) This does not mean that there will always be a problem when one of the conditions doesn't apply in a particular situation. In many cases, the “failure” is not so critical as to justify an intervention by the state, or the parties do not perceive of it as being so important as to merit the initiation of legal action or the termination of an amicable long-term relationship, or “government failure” is worse than market failure.

\(^{18}\) See Williamson (1996: 398) for the three versions of rationality: strong form (hyper-rationality-maximization-comprehensive contracting), semi-strong (bounded rationality-farsighted contracting), and weak (bounded rationality-myopic contracting). Although this distinction is relevant, it has the defect of not being continuous—a defect shared by many types of categorization. I would choose “rational spirit”, a term Williamson himself uses and prefers.
If all the aforementioned requirements are met, then the contract is perfect and it must be strictly enforced. But if one of them is not, then the contract is imperfect and there is a good chance that the parties will end up in court or that one party will be burdened by this imperfection so severely as to make future contracting parties inefficiently cautious. Contract law can provide solutions to this problem by creating doctrines that are suitable for correcting the defects of the market. These doctrines, embodied in default rules, will provide a “perfect-contract environment” for the parties, by reducing the probability of problematic situations. At the same time, parties will save time and money, i.e. economize on transaction costs (with both optional and mandatory default rules) and they will have a better chance of elaborating on more intricate aspects of their relationship, thus further reducing the likelihood of problems, since the cost of bargaining will be lower.

The majority of default rules should be subject to the will of the parties, who must preserve the right to alter them if they wish to. The insertion of mandatory rules in the context of a Civil code is essentially a public policy choice. Every distribution of rules, into mandatory and optional, has its own social benefits and costs. The most efficient distribution would be the one more faithfully based on the aforementioned market failure analysis.

Contract law has responded quite successfully to the demands of given markets and, as a result, there is a number of legal doctrines, in both Common and Civil law, that correspond to the imperfections of markets and can be seen as legal answers/solutions to the market failures just mentioned. The table that follows is characteristic:

<table>
<thead>
<tr>
<th>IMPERFECTION</th>
<th>CONTRACT DOCTRINE</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Irrationality</td>
<td>Majority, Incompetency, Transactional Incapacity</td>
</tr>
<tr>
<td>3. Negative Externalities</td>
<td>TORT LAW, Mandatory rules (rules of public policy)</td>
</tr>
<tr>
<td>4. Imperfect Information</td>
<td>Fraud and Misrepresentation, Frustration of Purpose, Mistake, Mutual Mistake, Duty of Disclosure, Unconscionability, Impossibility, Commercial Impracticability</td>
</tr>
</tbody>
</table>

19 These conditions are not as absolute as they seem. For example, the total absence of transaction costs is impossible, but this does not signify that all contracts will be imperfect by default. The concepts are relative (or rather, I am using them relatively), especially in real world situations, such as commercial transactions in a given modern capitalist economy.
I hope that the above exposition has made clear that economics can help us understand the economic rationale of legal rules. For economics, the market is not perfect. Law can greatly help in correcting its failures and this is the basic function of contract law. Promoting economic efficiency basically means correcting the market.

This surely sounds paternalistic. What if the parties agree on something which an economist would find inefficient? Richard Posner opts for the parties’ wishes, as shown in the following famous passage:

> Now consider what to do about cases in which the parties' intentions, as gleaned from the language of the contract or perhaps even from testimony, are at variance with the court's notion of what would be the efficient term to interpolate into the contract? If the law is to take its cues from economics, should efficiency or intentions govern? Oddly, the latter. The people who make a transaction – thus putting their money where their mouths are – ordinarily are more trustworthy judges of their self-interest than a judge [...] who has neither a personal stake in nor first-hand acquaintance with the venture on which the parties embarked when they signed the contract. So even if the goal of contract law is to promote efficiency rather than to enforce promises as such [...] enforcing the parties' agreement insofar as it can be ascertained may be a more efficient method of attaining this goal than rejecting the agreement when it appears to be inefficient. (Posner 2003: 96-97).

Before we proceed, we will deal briefly with the question of contract law's suitability for pursuing and achieving social justice. Although this is a nearly exhausted issue\footnote{For an overview of the issues of paternalism and freedom of contract, see Kronman & Posner (1979: 230-267) and for further elaboration, see Kennedy (1982) and Kronman (1983).} that we will not scrutinize here, we wish to call attention to two points:

(a) Contract is primarily an ingenious mechanism for the transfer of scarce resources.

The role of contract law and the state's function in general should be to help this mechanism
operate smoothly, and nothing else beyond that. The most reliable method for a contract law to achieve efficiency is for it to enforce the parties' deals and to “reconstruct” these deals when this is necessary, employing the standards of “trade usage” and “business ethics”.

These observations should not be taken to mean that there is no place for the intervention of the state and of judges in particular. This intervention seems necessary and inevitable in those cases where the disparities in bargaining power are conspicuous. But this intervention should have as its only purpose to enforce and thus facilitate exchanges and to create, to the greatest extent possible, a “perfect market environment”, by helping the market correct its failures and not by patronizing the parties. It is true that on many occasions the failures of the market can lead to unfair outcomes, resulting from highly unequal bargaining positions. But this is not always so. Most of the times, this inequality does not have any effects on the contractual relationship, especially in conditions of (practically) perfect competition. As Allan Schwartz (1986: 110) put it: If “[consumer markets] do work well, there is little to worry about in terms of justice – that is, justice in the sense of allowing people to do the best they can for themselves under given circumstances.”

(b) The state has numerous other opportunities for correcting injustices and pursuing “social justice” without distorting the market and harming people.21 It is generally accepted that contract law is not a suitable tool for achieving social justice and that other methods may be more efficient and more equitable, like taxation. “[J]udges can, despite appearances, do little to redistribute wealth [...] Legislatures, however, have by virtue of their taxing and spending powers powerful tools for redistributing wealth.” (Posner 1990: 359-360). Without any doubt, the pursuit of social justice by legislative bodies and not by the courts is not only more efficient, but also more comprehensive, democratic and impartial.

II. Civil Law and Economic Reasoning

I will now turn to our second question. Economic analysis of law is an American innovation and it was first applied in Common law. Is there any economic reasoning behind Civil law as

21 The prevailing view among economists is that contract law is not the right vehicle for social justice: “Why is that? Because not enforcing contract clauses, which is all judges can do, tends to make people poorer rather than richer.” (Schwartz 1986: 115).
there supposedly is behind Common law?22 In other words, is Civil law efficient or at least as efficient as Common law? To answer this question, I have decided to use contract law as the area of comparative analysis. The idea of my research project is very simple. In the areas where there is a significant difference between Common and Civil law, which law is more efficient? Which legal family is closer to economic reasoning?23

When I started working on comparative contract law twelve years ago, my first observation was the total absence of theoretical discussion and the parallel lack of contemporary grand theories developed for Civil contract law. By grand theories, I mean theories which purport to describe, interpret and even modify contract law in congruence with major philosophical, sociological, historical, political or economic theories claiming universality. On the other hand, if we look over the impressive literature published on contract law over the last two decades in the numerous Common law (especially American) journals and law reviews, we will discover that the purely doctrinal studies have been confined to the low-ranking journals. Nearly all the well-known American contract scholars (and there are many) can be easily categorized according to their adherence to a specific theory, most of them to law & economics. All of them discuss broad theoretical issues, even when they set out to solve particular doctrinal problems (Barnett 1999).

On the other hand, contract scholars in Civil law countries adopt a very different approach. The great majority of studies are purely doctrinal, there are very few references to philosophical, economic or other theories – and these few are largely outdated. Moreover, the topics are quite restricted, since the discussion on many issues seems to have come to a conclusion and the interpretation of the statutes appears to be exhausted. With the exception of certain “new” issues of some interest, like collective bargaining agreements, standard form contracts and electronic commerce, the rest of the law review articles are analogous to their counterparts in the low-ranking American law reviews.

What is the reason behind this almost total absence of theoretical discussion on contract law in Civil law countries? How can we account for such stagnation when there is such intellectual orgasm in the Common law? Are theoretical problems considered resolved in continental Europe? Is there an indifference towards theory and a predilection towards results in the Civil law countries, or is this just a sign of technical conservatism?

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22 The prevalent theory in law & economics maintains that the Common law process is the primary reason for the generation of efficient rules. See characteristically Rubin (1977) and the work of Richard Posner in general, mainly his treatise Economic Analysis of Law (Posner 2003).

23 This section draws heavily from Hatzis (2003b), where the interested reader can find a more sophisticated presentation of the argument.
One reason of the absence can be the major differences in intellectual legal traditions. But this cannot explain such disparity, especially if we take into consideration the intellectual resurgence in 19th century European legal thought. Another explanation could be that contract law was gradually divested of its substance by commercial law, insurance law, labor law, etc. But this is at least as true for Common law as it is for Civil law. In any case, it remains the core of any Civil code and the model of most legal relationships. In addition, it seems that a renaissance of contract law has occurred in the last fifteen years for two reasons: (a) the triumph of free market and capitalism in Europe-at-large which led, in Eastern Europe, to a drafting or revision of Civil Codes (esp. contract and property law) that are better-suited for free market economies and more conducive to economic development, and (b) the growing concern of the European Union for the unification of European private law in general and contract law in particular, as well as the trend toward the internationalization of contract law.

However, the continuing absence of general theories developed in Europe or influenced by the ones developed in Common law domains may at first seem puzzling for Common law scholars, until they realize what the most plausible explanation for this phenomenon is: in Civil law there is no need for theories since the legislator, mainly through the codes, has proclaimed what the law is and the judge is (supposedly) a mere interpreter, useful only for accommodating trivial twists of facts. In such a static universe, where is the need for theory?

By contrast, in Common law, theory is necessary even today, since there are no Codes capable of offering not only solutions to particular problems, but also – and most significantly – a unified approach. Common law has for centuries been (and today continues to be) in the process of its formation and Common law judges have tried to resolve issues by borrowing ideas, rules, and even theories, from multiple sources. With the advent of the industrial revolution and the pressure applied by novel commercial relations, and society in general, judges and scholars increasingly felt the need to inject the law with a theory that would provide a sense of stability and security to the contracting parties (see generally Atiyah 1979).

A typical characteristic of Common law theories, that is also a good illustration of our point, is the desperate attempt of Common law scholars to prove that their theories and their approaches are not only better normative theories, but also perfect positive ones. As a result, a rather strange phenomenon occurs in Common contract law review articles: after the exposition of a theoretical framework, the rebuttal of opposite theories and the discussion of several cases which are characteristic for their “compatibility” with the theory expounded, the author

24 See the essays in this volume and also Grundmann & Stuyck (2002). See also Grundmann (2002: 270-272) for the role of party autonomy in European contract law.
examines a number of controversial cases with the purpose of demonstrating that, deep down, these “irregular” cases are compatible with his theory, despite the opposite wording or even outcome.  

Only in extreme cases is a decision characterized as forthright wrong or (at least) opposed to the theory developed, and is consequently dismissed. Of course, another scholar may easily support a theory that is in diametric contradiction, and may interpret the decisions accordingly. This need for an “approval” by the already adjudicated cases (!) signifies the insecurity and the desperate need for coherence in Common law and is telling of the definitive power of precedent even today. This phenomenon of “procrusteanism” in Common law theory leads, according to one of the leading legal historians and Common law scholars, A.W.B. Simpson, to a sort of “doctrinal monism”:  

“[T]here has always in the Common law been a tendency towards a sort of doctrinal monism – there must be one test for the formation of contract (offer and acceptance), one principle governing possession, one test for the actionability of promises.” (Simpson 1975: 325).  

In stark contrast with Common law's century-long struggle for coherency, Roman law in continental Europe was so comprehensive, successful and coherent as to offer judges useful guidelines for the regulation of economic activities with no serious conflicts with the needs of economic life, despite the age of the statutes. It is characteristic that the history of contract theory developed by Common law within the last two centuries was, to a great extent, the history of the adoption and development of concepts that were part of Civil law's contract theory and practice since Roman times (or at least since the major codifications in Western Europe). The codification of Roman law by Justinian and the subsequent development of this law, always within the boundaries of the great codifications, and, at the same time, the successful and uninterrupted application of Civil law in continental Europe and elsewhere, has offered the contracting parties in Civil law countries a stable, coherent and positive legal...

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25 See e.g. Hillman (1997: 60-74). A characteristic historical example of this problem is the famous scene between Samuel Williston and Arthur Corbin in a session of the first Restatement drafting committee, as described by Gilmore (1974: 62-63). See also the excellent observations in Weir (1992).


27 James Whitman has developed a theory according to which this compatibility was to a great extent “helped” in the 19th century by the theoretical constructs of a number of German professors of liberal political ideology, mainly of Rudolf von Jhering. See Whitman (1990: passim and also 229-243). See also Rolland (1990: 143-145).

framework, including a set of default rules that they can bargain around – and thus further develop.

Its usage has also created a tradition of a particularistic elaboration of issues and economic relations, which is based not on a case-by-case treatment that needs a general theory in order to remain stable and coherent, but on a regulation of special types or categories of contractual relationships by means of a unified set of rules imprinted in the Civil codes. Alan Watson describes Roman law as comprised of numerous self-contained “blocks” (Watson 1981: 18-20). These rules have for centuries been the object of further treatment, elaboration and improvement by judges, scholars, and of course, the contracting parties themselves. This “fermentation” process has shaped legal orders that are time-honored and thus highly sophisticated. Therefore, it is no coincidence that Roman law was a decisive factor for the creation of the first commercial societies in Europe and for the rise of capitalism. After all, the Roman economy was essentially a market economy. According to Andreas Wacke (1993: 2):

*The ground rule of the Roman emperors with regard to private economic activity may be described [...] as laissez-faire liberalism, which only sought to regulate to a limited extent the production of mainly agrarian and household goods, as well as their distribution on the predominantly small-scale markets [...] The market-economy principle of free competition remained, by and large, undisturbed by these state activities, which were important, but which remained peripheral to the general economic system.*

As a result, Roman law was developed in order to meet commercial needs and to regulate an advanced commercial society and its transactions. It is illustrative of the contribution of Roman law to the economic development and the modernization of European legal systems that the enemies of Roman law in Germany attacked it as a law that was “rationalistic”, “commercial” and “materialistic” (Whitman 1994: 228). In a series of papers and books, Prof. James Whitman (1990; 1994; 1996), has established the close relation between the reemergence of Roman law and the birth of the first commercial society in Holland.29

The major codifications that started in the beginning of the 19th century and ended in the early 20th century offered a modernized version of Roman law. These codifications rendered the law more compatible, in certain respects, with the economic developments of the period. Further, they were the product of an extensive theoretical discussion and were greatly influenced by the social and economic theories that prevailed at the time, which were not very different from the present mainstream ones.

29 According to Whitman (1996: 1845), “Roman law did not cause the rise of a new commercial morality in seventeenth-century Holland; it helped justify the rise of a new commercial morality”.
Following the tradition of Roman law, the new Civil Codes have not espoused any particular theory, especially in the area of contract law. The main concern for the codifiers was to solve all major theoretical and practical problems by choosing the best possible solution for the welfare of the parties, as this welfare was perceived under the liberal ideology of the day, which was also heavily influenced by Christian ethics, and certainly within the boundaries set by the rules, standards and principles that had proven successful for many centuries.

Consequently, in the Civil Codes one can find answers to almost all the doctrinal and theoretical problems which have preoccupied and still preoccupy Common law theory (e.g. the basis of contract, the rigidity of the “privity” doctrine, the enforcement of penal clauses, liquidated damages or third-party beneficiary contracts, the choice between different types of damages and specific performance, the problem of quasi contracts and unjust enrichment, the puzzle of precontractual liability, the controversial unconscionability defense, the nature of the “good faith” requirement, the compensation paradox, the differentiation between commercial impracticability with other similar cases of frustrations of contract, etc.). Civil law thus provided definitive and authoritative solutions to all the aforementioned problems, without restricting the parties by heavily regulating their contract.

In addition, most of the clauses in Civil law Codes are default, non-mandatory (i.e., optional) rules. The Codes routinely endow the judges with broad discretion by way of a series of general standards. Regardless of the practice of Civil law judges, their independence is not similar in nature to that of their Common law colleagues, since they need not be creators but interpreters of the law. Consequently, there is no urgent need for unifying theories resembling those that were developed in Common law, since Civil law judges are not expected to create law in the manner required of Common law judges.

This particularistic approach of Civil law has proven quite successful for a long time, if one judges by the absence of major intellectual controversies among Civil law scholars (at least in the area of contract law), similar to those taking place in Common law. Since this is a phenomenon common to nearly all European Civil law systems, one could safely say that it is not the outcome of a consensus based on “intellectual laziness,” conservatism or ignorance, but the result of: (a) the lack of major doctrinal problems created by the rise and fall of opposing philosophical paradigms, (b) a parallel absence of major economic or social distortions.

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30 For Dawson (1982: 596), problem solving rather than high-level speculation was the great skill of Roman jurists (as this is evident in the Digesta).
created by the application of rigid legal theories, and finally (c) a shared common-sense pragmatism (a Roman law legacy) that has guided interpretation as a technical skeleton key.

As early as 1960, Ernst Cohn, a London barrister practicing in both Germany and England, writes:

\[
A \text{ practitioner who has grasped the rules of the first book of the German Civil Code and those of the first part of the second book is thereby well equipped to deal satisfactorily with an astonishingly large number of everyday problems. A question which would require a common law practitioner to search in books of reference for one or several quarters of an hour could be solved by his Continental colleague completely satisfactorily in as many minutes. (Cohn 1960: 586)}
\]

Similarly, in a letter to the editor from “a retired American lawyer living in France”:

\[
\text{French contracts tend to be extraordinarily short and simple by American standards [...] This is partly because parties to business contracts usually don't try to anticipate every situation that could conceivably arise but are content to abide by the Code Civil." (Himel 1997: 5).}
\]

An indication of the superiority of Civil law, especially in the field of contracts, is that over the last two centuries, Common law has incessantly copied the institutions of Civil law. According to one of the major figures in comparative law & economics, Ugo Mattei, “[T]he influence [of the Napoleonic Code Civil] in England and the United States was far from superficial but reached deep and long lasting layers of the law” (Mattei 1994: 202).

All the above could indicate that Civil law is more efficient that Common law. However, one would need more evidence. Even today, Common law and Civil law are quite dissimilar in the field of contract law. These should not be exaggerated, since the similarities between them are numerous and more important, given the tendency of the Common law to borrow solutions from Civil law. Nevertheless, it would be interesting to explore the differences in the light of economic analysis in order to test the success of both systems. Which system of law is more efficient in those areas where such differences exist?

In my work, I have explored five areas where there are marked differences between Civil and Common contract law. These areas are contract formation (Hatzis 1999), the enforcement of liquidated damages and penal clauses (Hatzis 2003a), third party beneficiaries (Hatzis 1999, 2000), frustration of performance (Hatzis 1999) and efficient breach (Hatzis 1999, 2000). As my research showed, the solution provided by the Civil law systems in these five areas where major differences are observed is more congenial to the one advocated by economists as the most efficient one. This is extremely important given the influence that
Common law has exerted to the economics of contracts, as Eric Brousseau (2001) has aptly demonstrated.

The particularistic (casuistic) and pragmatic approach of the Roman and Civil law has proven to be more efficient than that of the rigid theoretical Common law, whose reluctance to adopt all the successful solutions given by the Civil law (although it has already adopted most of them) is primarily due to the futile attempt of Common law scholars to create unified theories, based not on economic efficiency (the real and primary purpose of contract law), but on philosophical and moral ideals that are irrelevant to the parties’ wishes and welfare.

This does not necessarily mean that Civil law's underlying logic is economic (a feature that Judge Posner and other law & economics scholars attribute to Common law). But it does make the point that the long process from Roman law times to the modern Civil Codes and the parallel testing of its rules by a host of legal scholars, judges and lay people in diverse social and economic settings, have shaped institutions that regulate the market efficiently.

My hypothesis also does not imply that countries with Civil law systems are wealthier or more efficiency-oriented than Common law countries. The evidence suggests that rather the opposite is true. According to Paul Mahoney (2001), Common law countries experienced faster economic growth than Civil law countries during the period 1960-1992; the difference reflects the Common law's greater orientation toward private economic activity and the Civil law's greater orientation toward government intervention. However, I believe that this disparity should rather be attributed to different cultural traditions and historical circumstances.

III. Testing the Theory – The Case of Efficient Breach

To test my hypothesis, I am going first to discuss a problem that has preoccupied law and economics scholarship for many years: “efficient breach” induced by a third party.31

In certain cases, the breach of a contract is more efficient than its performance. “Breaching is more efficient than performing when the costs of performing exceed the benefits to all parties” (Cooter & Ulen 2004: 254).32 According to Judge Posner, this means that “[i]n many cases it is uneconomical to induce completion of performance of a contract after it has been broken”. Thus, the law should not compel adherence to a contract, but it should let the con-

31 For a more detailed elaboration, see Hatzis (1999: 170-194; 2000).
tracting parties decide whether they want to perform the contract or compensate the other party for the injuries incurred by non-performance. This is not a new idea. According to Oliver Wendell Holmes, Jr. (1881: 301):

*The only universal consequence of a legally binding promise is that the law makes the promisor pay damages if the promised event does not come to pass. In every case it leaves him free from interference until the time for fulfillment has gone by, and therefore free to break his contract if he chooses.*

More recently, in *Patton v. Mid-Continent Sys.*, 841 F.2d 742 (7th Cir. 1988), Judge Richard Posner writes:

*Even if the breach is deliberate, it is not necessarily blameworthy. The promisor may simply have discovered that his performance is worth more to someone else. If so, efficiency is promoted by allowing him to break his promise, provided he makes good the promisee's actual losses.*

For the breach to be efficient (i.e. socially desirable), the compensation must be full, i.e. the non-performing party should pay expectation damages, thus placing the victim of the breach in as good a position as he would have been in if the breaching party had performed – otherwise the breaches will be inefficiently underdetered.

Nevertheless, even law and economics scholars acknowledge that expectation damages which are actually awarded by courts are typically imperfect. Determining the extent of damages in litigation is a specific form of what economists call the “problem of preference revelation”, i.e. closing the gap between objective prices and subjective values. As we will see below, the only satisfactory solution to the problem of idiosyncratic values could be the enforcement of liquidated damages (i.e. damages stipulated by the parties).

Sometimes efficient breach is the result of a third party's interference in a contractual relationship, an interference that takes the form of a better offer by the third party to the promisor. This interference has been characterized as tortious in Common law, esp. in American law, but also in other jurisdictions. This “criminalization” of the better offer by a third party has been widely disputed by lawyers and economists as creating inefficiency (e.g. Wexler 1994, Hatzis 2000).

As Remington (1999: 646) correctly points out, “[t]he view of breacher as wrongdoer is quite inconsistent with modern contract law. When the tort of interference with contract is founded on this view it leads to the spectacle of tort law seeking to deter the very same behavior that contract law encourages.” Contract law encourages investment by enforcing promises and ensures full compensation for the aggrieved party in case of a breach. This latter compensatory goal of contract law would be undermined by the “deterrence” model of a tortious approach to the problem of breach (based on a tort-like conception of contract). If we accept that the basic goal of contract law is the efficient allocation of resources in a society and the ensuing wealth maximization and
The essential legal question appears to be the following: given the practical problem of calculating expectation damages, the corresponding high administrative costs and the parallel (and consequent) appearance of opportunism, in most situations, should we allow efficient breach or should we adhere to a theory that sanctifies promise, consent and/or good faith? The ethical dilemma which surfaces is that the two regimes can lead to quite different distributive outcomes. In a regime where efficient breach is not allowed, the new surplus (by the better offer) will be shared by the third party and the promisee, but in a damages/efficient-breach regime the surplus will be divided between the third party and the promisor.

In a seminal paper, Goetz & Scott (1977) emphasized the proof problems inherent in fully recovering idiosyncratic values. These problems prevent the non-breaching party from recovering his subjective expectations, if recovery is limited to legally determined “objective” remedies. Accordingly, efficiency will be enhanced, under many circumstances, by the enforcement of liquidated damage clauses that represent the most efficient means by which parties can insure against the otherwise non-compensable consequences of breach.

Promisees can always ask for penal clauses or high liquidated damages, reflecting their subjective valuation of the contract or their risk-aversion respectively. Those who are risk averse or value performance higher than its market price can insure themselves or can ask for either a penal or a “liquidated damages” clause to be included in the contract. This way, the promisee who has concluded an ordinary contract in a competitive market will be less protected than the one who struck a deal that he considers unique for personal reasons.

The essence of the free market is competition and this includes offering someone a better deal. The “criminalization” of competition can bring about only distorted effects, since the incentives to search would be diminished and the outcome cannot be Pareto optimal. Contract is a mechanism invented to be used for better allocating resources. If this allocation can be improved with the non-performance of a contract and without injury to anyone, i.e. if there is a way to a Pareto improvement, then the purposes of contract law have been achieved.

As I mentioned before, the mainstream approach in Common law today has led to the tortification of efficient breach. A third party cannot offer a better deal without putting itself in danger of being liable for “inducing breach”. According to Joseph M. Perillo, the author of the most widely-used American contract law textbook (2000: 1106): “[R]egardless of the

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not the enforcement of promises for moral reasons (as some libertarians would argue, see esp. Fried 1981, but also Scanlon 1990: 205-209 for similar views) or the protection of the sanctity of contract, then the choice is obvious. The pursuit of both goals would lead to serious indeterminacy.
soundness of efficient breach theory in economic science, it is not, and should not be, the basis of normative determinations in the legal system”.

The Romano-Germanic family of Civil law proves to be more compatible with the economic approach. A contract is just a promise to perform or to pay damages instead. It does not transfer any property right to the promisor and a tort for the “inducement to breach” sounds exotic to most Civil lawyers.

According to the principle of the “relativity of obligations” (the counterpart of the “privacy doctrine” under Common law), a contract creates a personal bond between the two contracting parties that binds only the two of them. Third parties cannot obtain rights or be burdened with duties from this two-party contractual relationship. Thus, a contract – or a juridical act in general – can only be considered a covenant between the two contracting parties and does not constitute a legal rule that is to be respected by third parties.

One of the results of this principle is that only the contracting parties have the obligation to comply with the contract and only the parties can be held liable for its breach. A third party cannot “breach” a contract; even when he is an accomplice to its breach, he cannot be held liable and his acts cannot be considered unlawful as such. The creditor in a contract does not have an absolute right to the performance of the debtor or to the object of performance – let alone any power on the debtor himself.

Thus, according to the associate principle of “separability” (Trennungsprinzip) in the exchange of a good (especially of an immovable good), two contracts are necessary for the transfer. “There is a difference, between transferring of Right to the Thing; and transferring, or tradition, that is, delivery of the Thing itself.” (Thomas Hobbes, Leviathan, I, 14). For the movement of a good from the property of the seller to the property of the buyer, two different contracts must be concluded: a wholly executory “promissory” contract, that creates an obligation to the seller to perform (i.e. to transfer the ownership of a property right) and is essentially an agreement to sell, and a dispositive “performance” contract, that transfers the ownership (the property right) permanently to the buyer and constitutes the actual performance.

In the example of a sale, the promissory contract creates an obligation on the part of the seller to transfer ownership of the object of sale and to deliver it to the buyer. In a second stage, another juridical act, regulated by property law, needs to take place for the sale to be concluded, i.e. the actual transfer of the right. This act is also considered a contract, even though it is essentially the performance of a promissory contract.

However, the parties in everyday transactions most often use one single contract for the promise to transfer and the actual transfer of a right or a good. Nevertheless, the theoretical
(and practical) importance of the principle is enormous. The “legal fiction” of the explicit separation of promise from performance (although it could be characterized as outdated and impractical, or even as antithetical to the principle of freedom of contracts), solves a number of problems that have plagued Common law scholarship and have created a tension between American contract law scholarship and economics. The most persistent of these problems is the restraint to efficient breach created by the tortification of its inducement by a third party and the simultaneous problematic nature of “promise” that is often treated as a property in a system where there is nothing similar to the principle of separation.

The problem of the tortification of efficient breach is essentially non-existent in Romano-Germanic legal scholarship. A contracting party can freely breach a wholly executory promissory contract. The creditor only has a claim for damages and does not have any right to the object of performance or to performance itself. Even the wording of the articles in most European Civil Codes does not essentially diversify between culpable and non-culpable impossibility of performance (Stathopoulos 1995: 262-263). Finally, the creditor cannot have any claim against the third party, since his inducement of the “efficient” (or inefficient) breach per se is not characterized as a tort.

Thus, Romano-Germanic legal theory and practice, following an old and successful Roman law fiction that has been preserved by the Romano-Germanic law family as part of its legal heritage, has managed to deal effectively and concurrently with the problems generated by externalities from contracts, efficient breach and protection of idiosyncratic values.

IV. Testing the Theory Again – The Case of Penalty Clauses

This is going to be more clearly illustrated in the example of agreed damages and especially of penalty clauses. Common law judges are quite reluctant to enforce liquidated damages, especially if they believe that they include penalty clauses which are not enforceable (Farnsworth 1999: 841-850, Beatson 2002: 624-629). On the other hand, in almost all European contract laws, liquidated damages are readily enforced, as are penalty clauses when they are not extravagant (sometimes even then) and purely gambling.

Although most law & economics scholars have criticized Common law courts for the non-enforcement of penalty clauses (Goetz & Scott 1977), there is a sizable minority of

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34 This section is based on Hatzis (2003a), where one can find a more detailed analysis.
scholars who defend the Common law “non-enforcement” policy on the ground that penalty clauses are inefficient because they hinder efficient breach, that is, breaches that confer a greater benefit on the contract breaker than on the victim of the breach, in which event breach plus compensation for the victim produces a net gain with no losers and should be encouraged (De Geest & Wuyts 2000). If this was true, then Common law would be more efficient than Civil law in this particular area. However, and despite the merits of the arguments deployed by scholars who advocate the non-enforcement of penalty clauses, we believe that Common law's rejection of penalty clauses is inefficient. We further argue that the Civil law solution to the problem is not only comparatively more efficient, but can also put at rest the worries of scholars who are afraid that efficient breaches will be deterred.

In the United States today, the parties may negotiate a clause providing for compensation in the form of a specified amount of damages in case of breach or of defective performance. These contract clauses are usually scrutinized by the courts which compare them to conventional damages. If the difference is substantial (if liquidated damages are “unreasonably” high or grossly disproportionate to the actual injury, according to the court) the relevant provisions of the contract are considered as penalty clauses and are not enforceable. The courts then award a conventional remedy to the injured party as if the contract was silent and there were no agreed damages to be paid in the event of a breach.

It seems that the main reason for this distrust of stipulated damages by Common law judges lies in their aim to avoid the introduction of any form of punitive damages (in addition to compensatory damages) for the breach of a contract.35 The reason is that supposedly “the mere availability of such a remedy would seriously jeopardize the stability and predictability of commercial transactions, so vital to the smooth and efficient operation of the modern American economy.” (General Motors Co. v. Piskor, 281 Md. 627, 381 A.2d 16 (1977). According to Farnsworth (1999: 787), “it is a fundamental tenet of the law of contract remedies than an injured party should not be put in a better position than had the contract been performed”.

English law is also quite ambivalent towards liquidated damages and penalties. English courts have, like their American counterparts, “retained the jurisdiction” to control the content of similar clauses. Liquidated damages are accepted to the extent that they are purely compensatory and not punitive. Even though English courts are not as unfriendly to liquidated damages as the American courts, they have formulated a similar test with the one employed in

35 See e.g. Restatement (Second) of Contracts §356, comment a: “The central objective behind the system of contract remedies is compensatory, not punitive”.

American case law to separate liquidated damages from penalty clauses.

However, the Common law non-enforcement of penalty clauses incited the critique of economists quite early. This critique was not only rooted in the traditional economists’ distrust of any kind of paternalistic judicial intervention in economic relations in general, but also in the very important economic role played by penalty clauses in commercial transactions.36

For economists, liquidated damages are far superior to the conventional damages awarded by the courts since they have been designed by the parties themselves. The parties have the incentives to stipulate damages that are not under- or super-compensatory, but serve the purpose of full compensation. In most cases where the liquidated damages appear to be under- or supercompensatory, this is a mirage. The parties know better than anyone else their subjective valuations of goods and performances and their stipulations serve their idiosyncratic values (Goetz & Scott 1977: 558-577). But even when the damages are in fact under- or supercompensatory, this might mean, respectively, that the parties decided to share the risk of a future change in circumstances (undercompensatory damages)37 or to include an insurance premium (supercompensatory damages).

Thus, when one contracting party is risk-averse and/or places a high subjective valuation on performance of the contract and the other party is the best possible insurer against his loss, then it is only rational for the parties to include an insurance (“penalty”) clause in the contract. The reason why a promisee often prefers a penalty clause which is essentially an insurance clause to a third-party insurance contract (besides the fact that he economizes on transaction costs) is that quite often the insurance compensation cannot adequately cover damages that are nonpecuniary. Additionally, a subjective value which is much higher than the market price may require a very high premium.

On the other hand, with a slight increase in contract price (due to the inclusion of the penalty-insurance clause) the promisor will take extra care in his performance. Since most of the times both parties wish just that (a more than average-quality credible performance in return for a more than average-price), the non-enforcement of these clauses by the courts is certainly inefficient and leads to undercompensation. At the same time, the court does precisely what it tries to avoid: By prohibiting a supposed windfall to the injured party, it awards an actual windfall to the breaching party, since the penalty clause reflects an above-the-market-36

36 According to Farnsworth (1999: 842-843): “Today the trend favors freedom of contract through the enforcement of stipulated damage provisions as long as they do not clearly disregard the principle of compensation.”

37 See esp. Friedman (2000: 151) (it may be perfectly reasonable to choose a penalty clause, in the expectation that it will rarely be invoked, over the alternative of giving the court a free hand to decide damages).
rate contract price since it includes an insurance premium. The breached contract embodies an insurance policy written by the promisor in favor of the promisee – which is never going to be compensated!\(^{38}\)

Moreover, the enforcement of liquidated damages solves a number of problems of contract remedies, but also of real-world contract relations:

(a) It solves the paradox of compensation (efficient breach v. efficient reliance – Shavell 1980) in a better way than the conventional remedies, producing the socially optimal solution, since reliance and breach are chosen efficiently.

(b) It facilitates the calculation of risks, since it eliminates uncertainty and helps future planning by the contracting parties. In fact, the damages stipulated by the parties will always allocate the contract risk optimally when the parties are risk averse, because the liquidated damage payment will equal the optimal damage payment.

(c) It discourages opportunistic behavior by the promisor and inefficient contract renegotiation and modifications.

(d) It reduces transaction costs (measurement problems for expectation damages and reliance damages, litigation and administrative costs, the cost of legal error when the miscalculation of the expectation damages leads to inefficient behavior, the cost of circumventing an inefficient rule by the parties and their attorneys, direct policing costs, etc.), especially in cases where the damages are not readily ascertainable.

(e) It simplifies efficient breach since the breaching party, knowing exactly the amount of damages that he has to pay to the promisee in the event of a breach, can easily determine if he would be better-off after the breach. At the same time, it precludes inefficient breaches caused by a hidden subjective valuation that is higher than the market (contract) price. In any case, post-breach bargaining is always available and can reduce the likelihood of an inefficient performance. The stipulated remedy provision in the contract would serve as a “bargaining entitlement”, encouraging the breaching party to share the benefits of an efficient breach with the injured party (Macaulay et al. 1995: 104).

(f) It helps young or inexperienced professionals to convey information about their reliability by offering a kind of “penal bond”, i.e. a risk premium. A penalty clause is the

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\(^{38}\) According to Collins (1999: 260) “[W]e cannot determine the issue of unfairness without investigating thoroughly the issue of whether advantages have been paid for in the price.”
least costly way (or the only way) for a promisor to communicate credibility to a skeptical promisee by signaling his commitment to perform.

For all the above reasons, most economists criticize Common law's penalty doctrine as inefficient. The non-enforcement of penalty clauses undercompensates parties with idiosyncratic values, leads to inefficient breaches and complicates efficient breach. Furthermore, it precludes parties to signal their reliability, it substantially increases administrative and litigation costs, it encourages opportunistic behavior, it leads to inefficient renegotiation, it disregards the allocation of risk by the parties, etc. For all these reasons, the penalty doctrine discourages contracting and is one of the main reasons why some value-maximizing contracts are never concluded.

However, some economists are concerned that the enforcement of penalty clauses might deter efficient breaches.39 When the liquidated damages are higher than the actual losses, then they are certainly inefficient, since they compel the promisor to perform even when the cost of performing exceeds the net benefits for everyone involved. Thus, when efficient breach is possible and an award of expectation damages could cover all actual losses, a penalty or a stipulated sum which is significantly larger than the amount required to compensate the injured party for his loss may operate in terrorem on the breaching party, deterring breach and compelling inefficient performance.40

There are also significant distributive consequences: in case of a possible efficient breach, a penalty clause serves only to increase the expected surplus of the original contractors relative to the incumbent. It does not increase the overall expected surplus and it creates a barrier to entry. Thus, a limit on liquidated damages in this case enhances efficiency by preventing the parties from overcommitting (from a social perspective) to the original contract.

These arguments against efficient breach are valid to a certain degree and are rarely rejected by the scholars who support the enforcement of penalty clauses. However, this critique does not differentiate between the three different kinds of stipulated damages:

(a) There are arbitrary liquidated damages set high enough in order to compel performance and deter breach without the genuine consent of the promisor and without relation to the actual damages (“shotgun clauses”). The particular stipulated sum is not the result of a bar-

39 For the efficient breach and the importance of remedies in the decision between performance and breach, see the remarks by Judge Posner in Patton v. Mid-Continent Systems, Inc., 841 F.2d 742 (7th Cir. 1988).
40 See also Talley (1994) (the non-enforcement of contractual liquidated damages clauses is the economically efficient means of treating such clauses to encourage renegotiation and account for transaction costs) and Che & Chung (1999) (reliance damages are more efficient than liquidated damages if ex post renegotiation is possible).
gain between the two contracting parties, but it is usually inserted in the contract without the knowledge or consent of the promisor. Similar clauses are quite frequent in standard form consumer contracts. Of course, the contract price does not reflect the penalty or the excessive liquidated damages. In these cases, there is no real agreement between the parties concerning the penalty clause, which is the result of a monopoly environment or of the presence of any of several formation defects. The enforcement of this penalty clause, which is an inefficient contract term, will not enhance efficiency, since (besides being abusive) similar contract terms deter efficient breaches.

(b) There are penalty clauses (or higher liquidated damages) which are inserted in a contract because they serve a specific economic role. In these cases, the penalty clause is freely accepted by the parties, especially when the market is competitive and/or the contracting parties are sophisticated enough, which is always the case in commercial contracts. The non-enforcement of the stipulated damages which are the result of bargaining between the parties is inefficient and it hurts the very people it wishes to protect by offering them an alternative they do not want to retain (possibility of efficient breach) and expropriating from them an alternative they wish to have (adding an enforceable penalty clause to their contract). Efficient breach is not really an issue when a penalty clause plays an important economic role and the liquidated damages compensate actual losses.

(c) There is also a third category of penalty clauses (which is essentially a sub-category of the second) that might require special treatment: penalty clauses which are economically efficient and reasonable ex ante, but seem quite excessive ex post. These clauses are usually protective of risk-averse promisees or they play an informational role, substituting the lack of reputation.

According to Clarkson et al. (1978: 366-378), the enforcement of these penalty clauses may create a “moral hazard” problem, i.e. incentives for inefficient behavior by the parties when the damages calculated ex ante and included into the contract as liquidated damages are much greater than the actual losses. This situation is quite frequent, especially after a price fall.

Indeed, here overcompensation is due to the fact that the determination of damages was difficult or impossible ex ante and the actual losses are far lower. However, the stipulated amount in these cases constitutes the “expected value” of damages, a value that could also be much lower than the actual losses. Then the excess is not a penalty, but the result of the previous allocation of risk to the least cost avoider (who is usually the least risk-averse party). The non-enforcement of the risk allocation agreed by the parties themselves is not only inefficient,
but it undermines the economic role of contract as a risk-allocation mechanism.

Some of these caveats originated by economists who seem to overlook the fact that although one of contract law’s main purposes is coping with market failures, its primary goal is simply to enforce the parties’ wishes.

The problem of penalty clauses is one of the very few in contract law and economics to incite considerable disagreement among economists, but also among legal scholars. Most economists and most legal scholars might be in favor of the enforcement of penalty clauses, but we should acknowledge that the (sizable) minority has developed several strong and valid arguments against the enforcement of penalties. The reason for the existence of these conflicting arguments which often cancel each other out is that there are apparently two categories of penalty rules: efficient and inefficient. Efficient rules (second and third category) are the ones which serve an economic purpose. Inefficient penalty rules (third category) are purely gambling, unconscionable penalties. But these are almost by default scarce in commercial contracts between sophisticated parties (especially among corporations) and in most consumer (even standard form) contracts concluded in competitive markets.

The policy of non-enforcement has costs for the contracting parties: the non-enforcement of penalty clauses which function as performance bonds undermines efficient new firms which are not able to compete with inefficient established firms by offering higher bonds (Dnes 2005: 107). Additionally, besides doing harm to the sophisticated contractual parties, the non-enforcement of efficient penalty clauses does not adequately protect weaker parties since the rule can be easily evaded.

Thus, there seems to be no reason for Common law courts to adhere so strongly to enforcement authority. The most efficient policy is one that would differentiate between inefficient (abusive) and efficient penalty clauses. Courts should enforce penalty clauses in general and they should annul only those clauses that are abusive and do not appear to play a specific economic role. This is impossible under the rigid penalty doctrine of Common law. But it is exactly what most Civil Codes permit, if not invite judges to do.

Penalty clauses have been enforceable in Europe since Roman times (Zimmermann 1990: 95-113). They were employed in conjunction with all sorts of transactions and Roman lawyers toiled laboriously in drafting them. Not only were they enforced by the courts, but the rationale behind their enforcement was to help the promisee recover his actual losses (especially securing non-pecuniary interests), to reduce transaction costs, and to compel the promisor to perform according to the terms of the contract.

Today continental contract laws still abide by Roman law and enforce penalty clauses,
even excessive ones. Under Civil law systems, there is no reason to distinguish penalty clauses from liquidated damages since they are both enforceable. However, when a penalty clause is excessive (i.e. disproportionately high), courts have retained the discretion to reduce it to a reasonable amount – but only if the promisor asks for it. Nevertheless, the courts generally resort to this power in exceptional cases.

The turning point in the shift from the unlimited penalties of classical Roman law to the contemporary “equitable” approach was the final draft of the German Civil Code (BGB), where, after much deliberation and opposition by the adherents of the old liberal Pandectist doctrine, the power of the judge to limit excessive penalty doctrines was instituted. According to BGB §343, when the reasonableness of a penalty clause is judged by the courts, non-pecuniary losses and idiosyncratic values should be taken into consideration.

French law is more faithful to the Roman law's liberal approach. It is characteristic that the old article 1152 of the French (Napoleonic) Civil Code provided (following classical Roman law) that if the contract stipulates “a certain sum of damages, no larger or smaller amount can be awarded.” This clause was amended as late as 1975. Under the amended statute, judges can at their discretion “reduce or increase the agreed penalty if it is either derisory or manifestly excessive”; thus, the new statute brings the French Code Civil in line with other European Civil Codes. However, in making this decision (which is in their pouvoir souverain), judges should take into account, as in the BGB, the purpose of the penalty clauses as stated by the parties and they should state the reason for the reduction.

The members of the Commission on European Contract law managed to combine the best elements of the two different European legal families in article 9.509 (Agreed Payment for Non-Performance) of the Principles of European Contract Law:41

(1) Where the contract provides that a party who fails to perform is to pay a specified sum to the aggrieved party for such non-performance, the aggrieved party shall be awarded that sum irrespective of his actual loss.

(2) However, despite any agreement to the contrary the specified sum may be reduced to a reasonable amount where it is grossly excessive in relation to the loss resulting from the non-performance and the other circumstances.

Judges obtain the power to intervene only when there is a “gross disparity” between the stipu-

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41 There is no provision on penalty clauses in the Vienna convention. This means that the parties will be able to enforce penalty clauses if the law of jurisdiction permits enforcement (Macaulay et al. 1995: 110). According to §7.4.13 of the UNIDROIT Principles: an aggrieved party is entitled to recover a specified sum “irrespective of its actual harm”, though the sum may be “reduced to a reasonable amount where it is grossly excessive in relation to the harm resulting from the non-performance and to the other circumstances.” This rule is identical to the one found in various Civil codes and in the Principles of European Contract Law.
lated sum and the actual losses. But the court cannot reduce the award to the actual loss; it can only fix an intermediate figure.

It is clear that Civil law is not only more efficient, but it also has the potential of accommodating the more sophisticated economic critique to penalty clauses. G.H. Treitel laments the Common law policy in his *Remedies for Breach of Contract* (cited by Whincup 1992: 261):

> The common law rules for distinguishing between penalties and liquidated damages manage to get the worst of both worlds. They achieve neither the certainty of the principle of literal enforcement, since there is always some doubt as to the category into which the clause will fall, nor the flexibility of the [civil law] principle of enforcement subject to reduction, since there is no judicial power of reduction.

My analysis has shown that Civil contract law is more efficient, or at least closer to the views of mainstream economic scholarship in its treatment of penalty clauses than Common law. As stated earlier, the most efficient policy on stipulated damages would require a differentiation between inefficient (abusive) and efficient penalty clauses. Courts should enforce penalty clauses in general and they should annul only those clauses which are abusive and do not appear to play a specific economic role. This “efficiency test” is possible in every Civil contract law, provided that judges will accommodate economic theory in their interpretation of contracts. There is no other criterion for differentiating between “reasonable” and “abusive” penalty clauses than the one offered by economic theory.

Economic theory will make the interpretation more sophisticated by offering the judges a perspective that is absolutely necessary for their treatment of problems such as (but not restricted to) the opportunistic deterrence of an efficient breach, the problem of credibility of young professionals and the impact of their decision on all kinds of transaction costs.

**V. Conclusion**

The European Civil Codes have proven overall successful after many decades of constructive implementation. Their particularistic approach towards contract law and the absence of rigidity contributed to the facilitation of economic life and to the realization of the parties' wishes
more successfully than in the Common law.\textsuperscript{42} This was the result of a natural evolution of legal rules and practices that threw into disuse a number of worthless institutions and insignificant formalities. It was also the outcome of the judges' respect for the principle of freedom of contracts and the absence of an activist judiciary, similar to the one in the United States.

The main obstacle to economic analysis in Civil law countries might be the absence of an intellectual tradition similar to that of Common law countries (i.e. a tradition of respect for individualism and/or economic efficiency). But we should not overestimate these culturally-specific conditions, especially after taking into consideration the trends in international economic relations, the globalization of economic activity, the deregulation influx and the discrediting of political theories that could create a hostile environment for the growth of economic analysis.

We dare suggest that a Civil law country has even better prospects for the application of such theories than a Common law country.\textsuperscript{43} Currently, in most Civil law countries (at least in Europe) any attempt to deregulate economic life and to create an economically efficient law comes primarily from the state and not from the judicial system or legal scholarship. Thus, the timing is perfect for the sophistication of contract law in these countries. Specifically, as concerns the European Union, the attempt to unify the private law of member states in recent years, the publication of tentative drafts and the enactment of many EU directives on contracts, present a golden opportunity for modernization based on economic analysis.

In this paper I argued that the absence of theories developed for Roman contract law and the absence of grand theories developed in Civil contract law scholarship were outcomes of a particularistic approach to the problems created by the deficiencies of markets. This approach was driven by the need for a construction of a legal framework conducive to economic progress. The generation of efficient results by Civil law through the selection of efficient rules and standards was completed over the course of several centuries and stabilized after the great codifications.

Common law had for centuries attempted to develop a similar construct that would be stable enough to facilitate economic relations. The borrowing of ideas and solutions from Civil law was the easy way out. Despite the numerous legal transplants, Common law fought hard to preserve a false independence and a parallel dilapidated coherence by building uni-

\textsuperscript{42} For a similar conclusion, see Tullock (1997: 53-59) (European procedures are far superior in clarity, precision and implementation to Common law procedures) and Deffains (2005) (those who build and implement civil codes contribute towards realizing an efficient regulation of human activities).

\textsuperscript{43} See also the recent views of Richard Posner in Posner (2004).
fied, conclusive, but dogmatic theories. The mimicking of Civil law has no doubt led to some efficient results, but with many islands of “inefficiency” in the sea of rigid theories.

In a recent decision (XCO International Inc. v. Pacific Scientific Co. U.S. Court of Appeals for the 7th Cir. May 24, 2004 – yet unpublished), appellate judge Richard Posner, the father of law & economics and the one who first developed the theory of the efficiency of Common law, has to enforce the rigid penalty doctrine of Common law although he thinks it is inefficient! He writes:

*The reason for the rule is mysterious; it is one of the abiding mysteries of the common law. At least in a case such as this, where both parties are substantial commercial enterprises (ironically [in this case], it is the larger firm, that is crying “penalty clause”), and where damages are liquidated for breach by either party, making an inference of fraud or duress implausible, it is difficult to see why the law should take an interest in whether the estimate of harm underlying the liquidation of damages is reasonable. Courts don’t review the other provisions of contracts for reasonableness; why this one?*

He will give the answer some pages later:

*The slow pace at which the common law changes makes it inevitable that some common law rules will be vestigial, even fossilized.*

On the other hand, Civil law scholarship and practice is going to find it increasingly difficult to respond to the fast-changing economic circumstances. For the first time in history, economic relations have become so complicated that it is impossible for a judge endowed only with common sense to solve problems created by the dysfunctions of markets. Economic expertise is not merely helpful; it is indispensable. Of course, judges are not expected to invent the wheel – but they should definitely learn how to use it. A responsive economic theory of contract law is imperative if Civil law is to continue playing the role that it has successfully performed for centuries: providing the legal framework that helps the economy function.
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