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Title

The Moral-Hazard Effect of Liquidated Damages: An Experiment on Contract Remedies

Permalink

<https://escholarship.org/uc/item/1k67n9cb>

Journal

Journal of Institutional and Theoretical Economics, 173(1)

ISSN

0932-4569

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Publication Date

2017

DOI

10.1628/093245616x14785139251422

Peer reviewed

Comment: Contract remedies: ex post versus ex ante. by Ben Depoorter, Lars Freund, and Sven Hoeppner

by
Alexander Stremitzer

1 Introduction

There are many reasons why it might be beneficial for contracting parties to stipulate liquidated damages. First, doing so reduces informational burdens, relieving courts from ascertaining damages. This makes for quicker, less risky, and less expensive litigation. Second, liquidated damages allow parties to contract around the reasonable certainty requirement and the foreseeability requirement. This restores some level of contractual protection for victims of breach in cases where damages are highly subjective or damages consist in uncertain lost profit.¹ Third, properly stipulated liquidated damages can provide incentives for efficient relationship specific investment where standard breach remedies are unable to do so (see, e.g., Shavell 1980, 84; Cooter and Eisenberg, 1985). Finally, it was argued more recently that liquidated damages increase the willingness of parties to engage in efficient breach as it reduces promisors' motivation to keep their promises for deontological reasons (Wilkinson-Ryan, 2010).² All of these reasons have prompted prominent

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¹For a case of subjective damages see, e.g., *Deutsch v. Music Co.*, 453 N.E.2d 1302 (Ohio 1983), where a band fails to show up at a wedding and the court refuses to give damages for the subjective harm suffered by the plaintiff of not having music at his wedding. For a case of lost profit see, e.g., *Kenford Co. v. County of Erie*, 493 N.E.2d 234, 236 (N.Y. 1986) (lost profits could not be proven with 20-year projections for revenues and expenses of prospective stadium where there was only one other facility in the country to serve as a basis for comparison).

²This might be because the promisee, by accepting a liquidated damages clause, has consented to future breach, or because liquidated damages provides for an accepted way

scholars to advocate the use of liquidated damages despite skepticism by common law courts (see, e.g., Schwartz & Edlin, 2003).³

Deporter et al. (2016), argue that there is an underappreciated downside to introducing liquidated damages. The authors present evidence from an experiment and claim that a party who proposes to include a liquidated damages clause in a contract might face negative reciprocity by the other party. If true, this argument would add a cautionary note to the widespread enthusiasm for liquidated damages. It would no longer be necessarily true that the advantages of introducing such a clause would outweigh the disadvantages.

In my comment, I will first describe the paper’s argument. I will then point out a few concerns with the design of the experiment. My major criticism is that the authors’ experimental design is not well suited to answer the question it purports to answer. However, I will offer an alternative story, partly supported by present results, which is of interest both to legal policy and interpretation of current contracts doctrine.

2 Main Result and Criticism

In their paper, the authors compare levels of cooperation in a modified trust game across three main treatment conditions. Treatment BASE is a treatment where the trustor is unprotected by any remedy. This is equivalent to a case where there is no legal enforcement of contracts. Treatment LDT is a treatment where the trustor is protected by a liquidated damages clause (which the trustor introduces into the contract). Finally, treatment RDT is a treatment where the trustor is protected by a background legal regime.

The authors’ find that trustees’ cooperation levels under liquidated damages (LDT) are lower than under the background legal regime (RDT). Even more surprisingly they find that cooperation is lower than under no legal protection at all (BASE).

The results are broadly in line with previous results on the crowding out of intrinsic motivation by extrinsic incentives. LDT and RDT offer monetary incentives to cooperate but those incentives are not strong enough to make it in the trustees’ self-interest to cooperate. This is exactly the kind of scenario where introducing extrinsic incentives is known to be potentially counterpro-

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of compensating promisees for disappointed expectations.

³Common law courts often refuse to enforce a liquidated damages clause if it seems overcompensatory and therefore might constitute a penalty clause.

ductive.⁴ However, this still leaves open the question of why the crowding-out effect is stronger under LDT than under RDT. In other words, why is it that stipulating liquidated damages is inferior to relying on a background legal regime?

One reason for this result might be that the design requires the trustor to unilaterally introduce the liquidated damages clause, thereby signalling a lack of trust in the trustee. It is, however, unclear whether this design feature captures real world contracting. Usually, at the contracting stage, parties' incentives are aligned. The trustee knows that the trustor might be skeptical about whether the trustee will cooperate. This is because the trustor anticipates that cooperation is against the trustee's ex-post self-interest. The trustee might therefore voluntarily offer to introduce a liquidated damage clause in order to reassure the trustor and induce him to opt into the game. However, a clause introduced in joint negotiations between the parties or even on the trustee's initiative would be less likely to trigger negative reciprocity.

A second feature of the design is that the trustee never actually makes a promise to cooperate. This is odd as we would expect a trustee to make such a promise in order to convince the trustor to opt into the game. Moreover, a contract between the two parties would always contain such a promise. Given a promise to cooperate it seems less of an imposition to introduce a liquidated damages clause, even if such a clause is proposed by the trustor.

A third - more fundamental - issue is that the authors' design does not capture the actual decision of contractual parties who choose whether to introduce a liquidated damages clause. Parties thinking about introducing an liquidated damages clause face the choice of either relying on the background legal regime or *replacing* the background legal regime with a liquidated damages clause. However, the design in the paper gives parties the choice between stipulating liquidated damages or having no legal enforcement at all. It is clearly different to propose a remedy where there would otherwise be none, than to propose a remedy that replaces a default remedy which is just as onerous as - or potentially even more onerous than - the liquidated damages clause.

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⁴See, e.g., Frey and Jegen (2000) for a survey of experimental evidence for crowding effects in economic settings.

3 The paper's contribution

The paper's design is not well suited to answer the question the authors purport to answer, namely, whether contracting parties should stipulate liquidated damages clauses in their contracts. However, there is another important question that the paper addresses. Should there be a default regime if it is easy for parties to find a contractual solution of their own?

The classic justification for providing default rules is to save on transaction costs. If most parties would stipulate a breach remedy in their contracts it seems reasonable to provide for such a remedy as a (majoritarian) default. That way parties do not have to actually write such a remedy into their contracts saving on ink, paper, and negotiation time. Another potential reason for a default regime might be that, by providing for an inefficient default rule, parties are forced to think hard about the best contractual solution (see Ayres and Gertner, 1989, who call these default rules "penalty defaults").

The authors result can be interpreted to provide a third reason why providing a default regime might be beneficial. If introducing a remedy by contract triggers negative reciprocity, parties might not be able to introduce the same remedy as in the default regime by contract without suffering an additional cost. This argument is in the same vein as the argument by Spier (1992) which argues that asymmetric information can lead to contractual incompleteness as parties fear that proposing an efficient contractual solution (e.g., prenups) might signal something negative about themselves. In such a case, parties might end up with suboptimal contracts, and having a default regime - even if not perfectly tailored to the situation at hand - might improve the parties' welfare.

This argument would also have an impact on how to think about reasonable certainty and foreseeability doctrine. These doctrines lead to systematic undercompensation of victims of breach and also provide inadequate incentives for the breaching party to avoid breach. If parties can easily contract around these doctrines by stipulating liquidated damages, courts do not need to worry too much about these negative consequences. Refusing to enforce highly subjective or speculative remedies would then only force contracting parties - who are arguably in a better position to quantify those damages - to come up with a privately stipulated damage measure. In other words, those doctrines would be nothing else but penalty defaults shifting the onus of coming up with a remedy to the least cost avoider. If, however, stipulating liquidated damages comes at considerable cost for parties, courts should con-

sider being more open to freely estimating damages even in situations where harm is speculative and subjective.

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