

## STIPULATED DAMAGES, SUPER-STRICT LIABILITY, AND MITIGATION IN CONTRACT LAW

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*The remedy of expectancy damages in contract law is conventionally described as strict liability for breach. Parties sometimes stipulate damages in advance, and may agree that the damages they stipulate shall be the exclusive remedy for breach. They may do so because of their conviction that they can, even in advance, assess damages with greater accuracy than courts, and they may be wary of litigation costs associated with the postbreach determination of expectancy damages. This Article advances two claims. First, that the familiar expectation remedy is correctly understood to involve elements of fault. There is litigation over the question of fault with respect to the mitigation of damages. Stipulation, on the other hand, makes contract liability stricter because it takes the mitigation question away from courts. It allows less room for courts to modulate the remedy on the basis of the parties' relative fault. Stipulation often encourages mitigation by one party, but then, to make up for the strict liability character, the parties may stipulate in a more detailed manner to encourage bilateral mitigation. Mitigation considerations should change the way we think about many stipulated remedies. Second, while law is generally described as being suspicious of, or even hostile to, stipulation—in large part because courts refuse to enforce “penalty” clauses—in fact, law encourages stipulation. It does this by sometimes declining to award expectancy damages, often in the very situations where stipulation seems sensible, and also by providing expectancy damages where the award of stipulated damages is regarded as a penalty. These two claims illuminate cases on such diverse matters as residential leases, construction contracts, product warranties, service contracts with liability waivers, and no-show customers and their service providers.*

### INTRODUCTION

The remedy of expectancy damages plays a central role in the conventional statement of American contract law.<sup>1</sup> Specific performance is a

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1. It once would have been enough to cite L.L. Fuller & W. R. Perdue, Jr., *The Reliance Interest in Contract Damages*, 46 *YALE L.J.* 52, 59–62 (1936) (expectation must be protected to

smaller but well recognized feature, and it is prominent in some subsets of contract law.<sup>2</sup> Both rules are usefully described as providing strict liability, though occasional academic campaigns draw attention to the ways in which fault permeates contract law. Fault is, of course, the foundational rule of American, if not all, tort law, and there it is strict liability that plays the supporting role.

The conventional statement also has something to say about stipulated damages, a term I use to include liquidation to an amount of money, as well as limitations on damages, scheduled damages, and other means of specifying the remedy for breach in advance and by bargain. It is that when these damages are “too high,” measured either by actual damages expected at the time of contract formation or damages suffered by breach, courts will often disregard them as “penalty damages.”<sup>3</sup> The disappointed party is then normally free to revert to collecting expectancy damages.<sup>4</sup> There is also a small literature on “underliquidated damages,” and while such clauses might also be toxic to courts that hue to the expectancy-damage line of authority, they are more often acceptable.<sup>5</sup> Indeed, many waivers of liability can be understood as successfully stipulated low—if not rock bottom—damages.

This Article proceeds as follows. Part I locates stipulated damages in the firmament of fault, and shows that the remedy of stipulated damages outflanks that of expectancy damages on the strict liability spectrum. Contract law has been understood as deploying strict liability, but it is strict liability only to a point—because once the “duty to mitigate” is at issue, fault comes into play as courts consider the reasonableness of the post- and even the prebreach mitigation efforts. Through a variety of means, courts can modu-

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“promote and facilitate reliance on business agreements”), but specific performance and actual damages would, of course, also protect reliance. Eventually, even the most doctrinal voices came to see expectancy damages as the means by which American courts normally choose to encourage reliance on promises. *See* 3 E. ALLAN FARNSWORTH, FARNSWORTH ON CONTRACTS § 12.1, at 149–50 (3d ed. 2004).

2. For example, specific performance applies to contracts for unique goods, U.C.C. § 2–716(1) (2005), including transfers of interests in specific land. RESTATEMENT (SECOND) OF CONTRACTS § 360 cmt. e (1981); RESTATEMENT (FIRST) OF CONTRACTS § 360 (1932).

3. *See* U.C.C. § 2–718(1) (referring to reasonableness in light of the “anticipated or actual” harm or loss, and the difficulties of proof and of otherwise obtaining a remedy for breach); RESTATEMENT (SECOND) OF CONTRACTS § 356. The distaste for penalties may be related to the desire to prohibit gambling, but my strategy here is simply to accept the old results—and then to recharacterize the law in this area.

4. *See* *Lake River Corp. v. Carborundum Co.*, 769 F.2d 1284, 1287 (7th Cir. 1985) (Posner, J.) (“If the contractual specification of damages is invalid, Lake River still is entitled to any actual damages caused by Carborundum’s breach of contract . . . .”); FARNSWORTH, *supra* note 1, § 12.18, at 304 (“If a provision is condemned as a penalty, it is unenforceable. But the rest of the agreement stands, and the injured party is remitted to the conventional damage remedy for breach of that agreement, just as if the provision had not been included.”).

5. The subject was shown to be interesting in Elizabeth Warren, *Formal and Operative Rules Under Common Law and Code*, 30 UCLA L. REV. 898 (1983). The conventional view, however, continues to be that underliquidated-damage provisions present the completely different problem of unconscionability, if they present any problem at all. *See* U.C.C. §§ 2–302, 2–718 cmt. 1 (stating that unconscionability is the means of striking underliquidated damages).

late damages according to the parties' relative shortfalls in these efforts.<sup>6</sup> In contrast, when the parties stipulate damages, they leave courts with less room in which to operate. With stipulation, the parties agree not only to take expectancy-damage determinations away from the court, but also to remove questions about mitigation. The remedy of expectancy damages thus constitutes a mixed system; there is, famously, strict liability with respect to breach, but then there is fault—a kind of comparative fault—with regard to mitigation. A stipulated-damage remedy can therefore be characterized as super-strict liability because it does not normally vary according to the fault of the parties, even when we take postbreach behavior into account. I explore this conception of contract remedies, and the idea of stipulated damages as super-strict liability and as a means of removing mitigation from the purview of the courts. In doing so, I illuminate classes of cases where courts are more or less inclined to accept stipulated damages.

Part II proceeds to a second, independent point as it reexamines the conventional wisdom that law is leery of, or, in effect, discourages, stipulated damages—if only by dismissing those deemed to be “penalty damage” clauses. I suggest that the opposite is true. In fact, the law may actually push contracting parties toward stipulation. For example, the expectancy-damage remedy is sometimes eviscerated by courts and, knowing this, parties will sometimes choose to stipulate damages in advance. Alternatively, they may simply prefer more strict liability. The real rule of contract remedies is probably that contracting parties *should* stipulate damages, at least when a postbreach assessment of damages would require something more than a comparison of market and contract prices. If this is right, then it follows that contract law, at least in this realm, seems to prefer super-strict liability. This reconception of contract remedies focuses attention on the strengths and weaknesses of the remedy of stipulated damages, especially as it pertains to mitigation.

## I. STIPULATION, FAULT, AND MITIGATION

### A. *The Effect of Stipulated Damages on the Nonbreaching Party*

Consider a case where the parties stipulate damages and custom, law, or perhaps even the contract itself leads to the conclusion that the stipulation is, or approaches the status of, an agreed-upon exclusive remedy. Common residential leases fit this description. *A*, an apartment building owner, might agree in July to rent premises to *B* for a one-year period, beginning September 1, at a rent of \$2000 per month. Imagine that the lease agreement provides for a \$1500 deposit in the event of damages beyond normal wear and tear, and also for a \$2000 deposit to guarantee that the apartment will be held for the September occupancy. The latter money can be applied toward the last month's rent in August. In reality, the damage deposit is unlikely to

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6. See generally Charles J. Goetz & Robert E. Scott, *The Mitigation Principle: Toward a General Theory of Contractual Obligation*, 69 VA. L. REV. 967 (1983).

be understood as stipulated damages, and to do so would create a series of problems.<sup>7</sup> But consider the situation in which the tenant, *B*, fails to materialize on September 1, or announces just before that date that he will break the lease. My interest here is in expectancy damages versus implicit stipulation, and in the parties' mitigation efforts. Imagine that *A* is immediately able to find another tenant, *C*, who agrees to pay the rent *B* had promised. As a result, *A*'s damages are close to zero, and yet in most cases we expect *A* to retain the \$2000 deposit, perhaps because it is hard for *B* to learn of the agreement with *C*, because *A* is seen as a kind of lost-volume seller, or because the deposit compensates *A* (in a manner courts might subtly recognize without articulating) for those other occasions when it is very difficult to locate a new tenant. This is the situation where *A* does not find a new tenant for some time, say ten months. In theory, *A* might then collect \$20,000 from *B*, but these expectancy damages are rarely awarded. Parties to a residential lease have come to believe that if this part of the deposit is forfeited, it is the landlord's exclusive remedy. This belief or implied provision that this "deposit" amounts to stipulated damages, is like that which we attach to a storekeeper's sign declaring that there will be a \$25 charge for a bounced check. The amount is understood to be the exclusive remedy available to the storekeeper, though it could turn out to be higher or lower than the actual damages, despite the fact that the Uniform Commercial Code insists that a contract be clear about an exclusive remedy.<sup>8</sup> In the case of both the breach-

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7. For example, were *B* to destroy the apartment, we would expect *A* to be able to collect more than \$1500 from *B*, and if damage done by *B* were modest, we would expect *B* to get some of the deposit returned. This must be true even if the parties have sloppily or inconceivably written that their "deposit" is the exclusive remedy for damage. One way to think about the occasional judicial distaste for liquidated damages is to see that nearly all stipulations can beget overliquidation, with its risk of wasteful behavior. See Kenneth W. Clarkson et al., *Liquidated Damages v. Penalties: Sense or Nonsense?*, 1978 Wis. L. REV. 351, 369-72 (analyzing situations where breach inducement is more likely, and emphasizing the inefficiency of such inducement). Courts might strive to get at this problem by denying "penalty damages" even when the parties seem to have priced the danger in their contract, by looking directly for wasteful behavior in the cases before them, or by rejecting penalty clauses as a prophylactic measure to save themselves the burden of ferreting out antisocial behavior even when there is no evidence of it. Alternatively, if we accept the idea that stipulated damages amount to a strong form of strict liability, we might draw on the literature that celebrates the efficiency of strict liability with a contributory negligence defense. If a court were to enforce this \$1500, penalty-looking provision, it might be expected to do so only where there was no hint or evidence of contributory negligence on the landlord's part. This is not quite the efficiency formula suggested by Clarkson et al., but it is close:

(1) [I]f neither party has an opportunity or incentive covertly to induce the other party to breach, stipulated damage clauses should be freely enforced; and (2) if either party does have opportunity and might have incentive, the clauses should be enforced only if they are reasonable in relation to the damages sustained.

*Id.* at 352. An inquiry into the landlord's behavior seems straightforward; indeed it may seem implausible that most landlords could increase the likelihood that their tenants would inflict modest damage, beyond normal wear and tear. But it might be a small additional step to wonder whether a court might not look at the tenant's mitigation efforts.

8. See U.C.C. § 2-719(1)(b) (2005) (noting that provided remedies are optional "unless the remedy is expressly agreed to be exclusive, in which case it is the sole remedy."). Comment 2 emphasizes the point in clearer language: "If the parties intend the term to describe the sole remedy under the contract, this must be clearly expressed." *Id.* § 2-719 cmt. 2. In the landlord-tenant case, the duty to mitigate is a modern development, modifying the landlord's ability to leave the premises

ing tenant and the bouncing check, the stipulated amount is apt to be regarded as a reasonably good (*ex ante*) estimate of expectancy damages.<sup>9</sup> In the case of the check, actual damages might include another bank's fee assessed against the storekeeper's account, as well as the loss that occurs when the storekeeper writes checks based on an incorrect assessment of his own bank balance—all of which could be reasonably thought to add up to, or to average, \$25. Similarly, in the residential lease case, we might imagine that A, or even the typical landlord, averages one month to find a replacement tenant.

This apparent treatment of the deposit as stipulated damages seems efficient in this context. A is in the superior position to find a replacement tenant.<sup>10</sup> The fixed damage amount gives A the right incentive to find C, and at the best possible price.<sup>11</sup> If instead the rule were that B retrieved the deposit in the event that A quickly found a replacement, A would have diminished incentive to expend resources on the search. An expectancy-damage rule runs a yet more serious risk that A will underinvest in the mitigation process. It is tempting to observe that custom has produced the more efficient rule. It is, after all, custom that has glorified the deposit to a point where it has become the automatic and exclusive remedy for breach, at least in most residential settings, despite the ostensible rule that the remedy of expectancy damages constitutes the default and preferred remedy for breach in American law.<sup>12</sup>

If the law were to abide by expectancy damages, A would have an obligation to mitigate, and the court would have to confront obvious fact-finding questions as to whether A advertised, searched, and priced the place in a

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vacant and collect the remaining rents. 2 RICHARD R. POWELL, *POWELL ON REAL PROPERTY* § 17.01 (Michael Allan Wolf ed., 2008). Statutes emphasize expectancy damages and give no support for the convention that the landlord's exclusive remedy is the deposit. *See, e.g.*, CAL. CIV. CODE § 1951.2(a) (West 1985) (discussing the landlord's right to unpaid rents, subject to mitigation). More generally, when parties liquidate damages, they sometimes, but not always, indicate that their assessment represents an exclusive remedy in the event of breach. *See infra* text accompanying note 12.

9. There are also cases where the stipulated damages reflect the reimbursement of an upfront discount in order to induce a contractual relationship. For example, a cell phone owner might receive a discounted telephone at the start of a service contract, but owe a fixed amount in the event of early termination. Similarly, an employee might receive a signing bonus, with the provision that a significant amount is owed if the employee departs within a specified number of years. These sorts of payments fit in the present analysis, but they can be set aside as reimbursements, and in any event they do not implicate mitigation. In all three cases—residential leases, bounced checks, and cell phone contracts—I resist the explanation that the breacher is expected to be judgment proof, or that it does not pay to bring legal action. After all, landlords and tenants regularly sue over unreturned or insufficient damage deposits.

10. In contrast, a nonprofessional, low-volume landlord might have more success pursuing expectancy damages.

11. For an earlier observation of this point, that a fixed damage term can encourage optimal mitigation by one party, see Richard A. Epstein, *Beyond Foreseeability: Consequential Damages in the Law of Contract*, 18 J. LEGAL STUD. 105, 117 (1989).

12. In the case of commercial real estate, and in other settings, the understanding may be different, and I do not mean to overgeneralize. It is sufficient to see that stipulation can and does play the roles described here.

reasonable fashion as well as whether *A* was a lost-volume seller.<sup>13</sup> It is not that the parties know in advance much more than the court will know following breach, but rather that they may agree not to expend resources arguing about this matter. All in all, the stipulated-damage norm is nicely efficient in getting *A* to undertake the mitigation, as *A* internalizes the costs and benefits associated with the task of going forward once *B* breaches. And it does this without imposing the fact-finding costs associated with comparative fault, which is a way of describing the usual treatment of the parties' mitigation efforts.

### B. *The Effect of Stipulated Damages on the Breaching Party*

The contrast with comparative fault draws attention to *B*'s as yet unexplored behavior. Even if we assume that *B* has no capacity to find a subletting tenant or other substitute, *B* is in control of the information regarding his own likelihood of breach. He can inform *A* of his plans early or late in the game, and often decrease or increase *A*'s (and the social) losses in this way. In principle, the remedy of expectancy damages takes this into account; the reasonableness of *A*'s mitigation efforts will be a function of *B*'s, for mitigation is a joint venture. Thus, at first blush, super-strict liability is likely to be inferior when efficient mitigation requires precautions by both parties. Expectancy damages left room for an element of comparative fault with respect to mitigation. Stipulated damages appear to give one party, but one party only (*A*, the landlord, in our example) a strong incentive to mitigate.<sup>14</sup>

Stipulated damages can, however, have some effect on *B* through additional stipulation, or what amounts to more careful contracting by the parties. This form of more detailed stipulation is common in certain settings. For example, newly admitted law students are accustomed to terms under which they forfeit an increasingly large fraction of the first tuition payment as the date of their withdrawal, or change of heart, falls later in the calendar. Similarly, in the preceding example, *A* and *B* might have provided for *B* to forfeit a larger fraction of the deposit as the date of breach approached September 1. Without such refinement, stipulated damages may be super-strict in the sense that there is no fault determination, but also less-than-strict because the damages are capped.<sup>15</sup> As detail is added, stipulation can encourage mitigation on the part of both parties.

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13. These questions could arise even if only the deposit were at issue, as *B* would likely argue that the deposit is a ceiling on damages.

14. Of course, to the extent the litigation costs associated with expectancy damages' comparative-fault regime are very high, the apparent superiority of that scheme disappears.

15. Thus, in the example in the text, the \$2000 deposit is owed without any inquiry into mitigation, but it is less than strict liability in the sense that it offers only \$2000, rather than the \$24,000 that an expectancy-damage remedy might generate. For a case where stipulation provides super-strict liability, does not depend on mitigation (though it is likely efficient), and also should have avoided litigation over mitigation and damages, see *Barrie School v. Patch*, 933 A.2d 382 (Md. 2007), in which the court enforced stipulated damages of entire year's tuition where parents withdrew student from private school after specified date of May 31.

The preceding example illustrates that while expectancy damages may not normally depend on the reason for, or morality of, a failure to keep a promise, these damages are supposed to be sensitive to the parties' mitigation efforts, and in this regard reasonableness of behavior is very much at issue. We can imagine a fault-based system that inquires into the reasonableness of the breach itself, and we can understand stipulated damages as a system that comes close to eliminating fault as a factor in both pre- and postbreach activity. The expectancy-damage remedy normally falls in between these two, representing a kind of mixed (fault-strict liability) system, because once a breach is contemplated, losses that could have been avoided through mitigation are assigned according to a comparative-fault inquiry. In most cases, a strict liability remedy, such as the homemade one of stipulated damages, can give (at least) one party an incentive to mitigate.

The novel element in this picture of stipulation is that the parties may reason that a commitment not to spend resources trying to show that the other party was at fault will be cost effective. This is the key to the argument in Part II below, where I suggest that in many situations courts may share or simply accommodate this sense regarding the folly of calculating not only expectancy damages, but also the costs and benefits of various mitigation strategies. In these settings, the parties can see that they might need to forego expectancy damages—and they can choose to stipulate damages instead, or adjust to a high likelihood of (undeterred) breach.

The argument advanced thus far, that stipulated damages should be seen as a kind of super-strict liability, is meant to supplement the familiar notion that stipulation is simply a means of self-assessment, where the parties have more information about losses from breach *ex ante* than courts will have *ex post*.<sup>16</sup> Under this view, when losses are easy to calculate *ex post*, as they are when a defendant breaches the promise to deliver a good with an easily determined market price, there is no reason to encourage stipulation, and the parties themselves should have no reason to stipulate damages in advance. The connection between the relative ability of the parties and courts to assess damages, on the one hand, and the cost of encouraging and monitoring mitigation efforts on the other, will become clearer when we add to the picture the inclination of courts to encourage stipulation.

## II. ENCOURAGING STIPULATION

### *A. How Courts Encourage Parties to Stipulate*

Courts often decline to award contract damages because that remedy can be too speculative. In one representative case, a manufacturer delivered

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16. There is also the idea that stipulation may obviate the need to reveal proprietary information. See Omri Ben-Shahar & Lisa Bernstein, *The Secrecy Interest in Contract Law*, 109 *YALE L.J.* 1885, 1890–91 (2000) (describing a variety of contexts in which parties may avoid default rules or litigation in order to protect valuable information). The advantages to some parties of super-strict liability may thus supplement not only the self-assessment function of stipulation but other advantageous functions.

defective carpet to a dealer, yet the dealer's lost prospective profits were regarded as too speculative and conjectural to warrant recovery.<sup>17</sup> And in the famous case of *Chicago Coliseum Club v. Dempsey*, the club collected most of its provable expenses following the boxer's breach of an agreement to appear in an exhibition fight, but not its lost profits, because they were "dependent upon so many different circumstances that they are not susceptible of definite legal determination."<sup>18</sup> When new ventures are derailed by contractual breaches, it continues to be likely that courts will decline to impose expectancy damages, because the disappointed party's expectation is seen as difficult to measure, inasmuch as there is no track record of past profits from which to extrapolate damages.<sup>19</sup> Courts will, however, respect the stipulated-damage provisions in these sorts of contracts.<sup>20</sup> It remains difficult to predict when courts will decline to award damages because of the speculative nature of that remedy. Even if we set new ventures aside, there will often be wild and genuine disagreement over the damages caused by the breach of a commercial contract. Dempsey's escape from serious liability is easy to ridicule with the observation that although most losses are speculative, courts can marshal predictive evidence, much as entrepreneurs do their best to assess the profitability of various investments. Yet it is not uncommon for expectancy damages to be denied because of the speculative character of these predictions.

When courts deny expectancy damages, they effectively encourage stipulation in future transactions, especially because parties have nothing to lose by stipulating; even if courts disregard the stipulation, the option of expectancy damages remains. Conventional wisdom, however, suggests that contracting parties should be cautious about stipulation primarily because if the specified amount looks high *ex post*, there is the danger that a court will say it was also unreasonably high *ex ante*, when the parties ought to have been assessing expected damages. If so, the provision will be labeled a penalty and disregarded. But a better, and certainly contrarian, view is that on

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17. *Aldon Indus., Inc. v. Don Myers & Assocs.*, 517 F.2d 188 (5th Cir. 1975). The court declined to go along with a "general rule" that the anticipated profits of a commercial business ought always be regarded as too speculative, but it did say that, where anticipated profits are concerned, a plaintiff has a difficult burden of proof. *Id.* at 191 (quoting *New Amsterdam Cas. Co. v. Util. Battery Mfg. Co.*, 166 So. 856, 860 (Fla. 1935)). For another case where damages were thought too speculative, but where parties can be seen as having engaged in a kind of stipulation, see *Freund v. Washington Square Press, Inc.*, 314 N.E.2d 419 (N.Y. 1974), in which the court reduced damages to six cents because there was no reliable way to determine the lost book sales or, derivatively, the author's lost royalties from publisher's failure to publish, where the author had received a \$2000 advance.

18. 265 Ill. App. 542, 549 (1932).

19. See, e.g., *Drews Co. v. Ledwith-Wolfe Assocs.*, 371 S.E.2d 532 (S.C. 1988) (finding insufficient certainty to award lost profits but deciding to join the majority of jurisdictions in applying the "new business rule" as a rule of evidentiary sufficiency and not as an automatic preclusion to recovery of lost profits by a new enterprise).

20. See, e.g., *XCO Int'l, Inc. v. Pac. Scientific Co.*, 369 F.3d 998 (7th Cir. 2004) (upholding \$100,000 per year in liquidated damages where assignee allowed assignor's patent to expire, and noting that it was sensible for parties to stipulate damages where damages are difficult to determine).

balance the law actually encourages stipulation. If the parties do not stipulate, there is the danger that damages will be regarded as speculative. Stipulation allows the parties to avoid that result. And if stipulation is disregarded because of the penalty-clause doctrine, the injured party can still ask for and receive expectancy damages. The cost of stipulation is, therefore, the cost of assessment and negotiation (at least insofar as there will be no breach later on, so that these are wasted expenditures) and also the cost associated with the danger of underliquidation. This last cost, however, can normally be avoided by the parties' specifying that the stipulated-damage term is a floor and not an exclusive remedy. If, however, the payment of the stipulated damages is described as the exclusive remedy, then we can surmise that either the parties prefer their own *ex ante* assessments (and bargain) over a court's *ex post* determination or that they wish to commit to avoiding litigation costs.<sup>21</sup>

#### *B. Two Advantages of Stipulation: Knowledge and Mitigation*

I have already suggested that stipulation allows parties to opt for strict liability with respect to the question of mitigation. And we know that the provision of stipulated damages is also a means of estimating damages where the parties think that their knowledge and bargain are likely to be superior to the courts' determination of expectancy damages. The courts have the advantage of viewing the actual damages, while the parties cannot wait until after breach to assess damages because, by then, their interests are opposed. On the other hand, the parties have local knowledge and can vary the price of their contract. We might label this familiar, first-order reason for stipulation as "knowledge."<sup>22</sup> And by "mitigation" we could refer to the possibility of profitably avoiding the costs associated with litigating the consequences of various mitigation strategies, even at the expense of reducing the incentive to mitigate. Contractual agreement on stipulated damages might thus offer knowledge and mitigation advantages. And one way to think about the cases is to ask whether they present one or both of these features.

Of course, one risk of stipulation is that the parties sacrifice the comparative-fault inquiry that is buried within expectancy damages, as it pertains to mitigation; the parties may not want super-strict liability. Fortunately, when parties are encouraged to stipulate they are usually able to count on one party's mitigation efforts, precisely because the stipulated-damage clause gives that party a strong incentive to mitigate, as *A* was

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21. Note that courts are not simply saving themselves work in one place, damage assessment, in order to take it back on when evaluating claims that stipulated amounts should be excluded as "penalties." The latter inquiry is more relaxed as courts need not be precise in order to rule whether penalties have been provided.

22. And "knowledge" might be understood to include the protection of knowledge, as emphasized by previous commentators. See Goetz & Scott, *supra* note 6 (emphasizing throughout the problems of private knowledge and cooperation); see also *infra* note 24.

encouraged to do in the residential lease example above. The other party can then be induced into contributory mitigation with more refined stipulation.<sup>23</sup>

A natural question to ask at this point is whether it is good that knowledge and mitigation are “bundled” in the single tool of stipulated damages. The parties might agree to avoid litigating over mitigation, but they may think that a court’s *ex post* damage assessment is superior to their own *ex ante* guess. Conversely, they may prefer their own *ex ante* assessments, but be willing to risk the costs of later litigation over mitigation because of the incentive effects on mitigation. In principle, these problems can be solved and the solutions unbundled. Parties could stipulate damages in order to gain the knowledge advantage, but could provide that “the stipulated damages specified should be increased or decreased if either or both parties fail to take steps to mitigate the losses caused by breach.” I have not seen such a contract. Lawyers may sense that courts will misinterpret or fail to enforce such a mixed message about their own competence, or they may simply not have thought about unbundling. Parties could also try to waive solely the duty to mitigate. An agreement could provide that “the tenant shall take possession on September 1, and shall owe no damages whatsoever for failing to provide any notice regarding anticipated breach to the landlord before that date.” And, in between, contracts could try to specify what should or should not be taken into account in determining damages.<sup>24</sup>

*Dempsey* is a case where unbundling the knowledge and mitigation attributes of stipulated damages might have been useful. The club could have stated its expected damages *ex ante*, and *Dempsey* could then have priced the contract accordingly. It seems unlikely, though, that the parties would have chosen to stipulate in order to avoid the comparative-fault inquiry we associate with the duty to mitigate. The club might have mitigated, and received some return on its preparatory expenditures, by looking for a

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23. See *supra* text accompanying note 15.

24. In practice, parties inclined to stipulate damages in order to avoid litigation over mitigation will surely want to avoid litigation about expectancy damages, where they also enjoy a knowledge advantage. The reverse is less obvious. Parties may wish to exploit their own knowledge and take the determination of expectancy damages away from the court, but they may still fear losses from the failure to mitigate enough to tolerate litigation over those losses. Careful stipulation will help. For example, the carpet manufacturer (which may know its product is defective in time for dealers to stock other inventory), *Dempsey*, and surely the tenant, *B*, can all be encouraged to reveal coming breaches early in the game just as the withdrawing law student has an incentive to do, with clauses that increase their damages as the revelation date is delayed.

In some settings, parties turn to insurance, but this does not mar the point about bundling mitigation and knowledge. Thus, when a construction company is employed to build a bridge or renovate a place of business, the customer fears delay or abandonment. It might obtain or require a performance bond, and include that premium in the price of the contract. The surety’s price is one check on the feasibility of the project, and on the schedule of payments due from the customer, because it must stand ready to hire another firm to complete the project. Concurrently, the construction company may buy or require a payment bond, so that each side’s performance under the contract may be guaranteed. If the project is abandoned by the construction company, the customer (and the insurer with a right of subrogation) may make a claim for this breach. Under these circumstances, stipulation may be less attractive. The parties might respond to the unavailability of expectancy damages by demanding these sureties, and so we can think of the premium paid to an insurer as a kind of stipulated damages, but paid *ex ante*. This is surely a form of super-strict liability, where payment follows the activity rather than the breach.

substitute—though heavyweight champions are hard to find. Dempsey could have tried to do the same. The main claim here is that the very possibility of a court's declaring expectancy damages to be too speculative encourages future parties to stipulate. If they prefer a court to police mitigation, then the benefits of stipulation come at a substantial cost, although the parties can minimize this cost by agreeing on a schedule of stipulated damages.

*Fretwell v. Protection Alarm Co.* provides a contrasting case, in which the court upheld a contract between a homeowner and a burglar alarm company.<sup>25</sup> The contract stipulated \$50 as the limit of liability, but negligence by the company's employee, who failed to notify the police, arguably caused the homeowner's \$90,000 loss.<sup>26</sup> In contrast to *Dempsey*, not only did the parties stipulate here but also their concern would surely have been about litigating over mitigation rather than assessing damages. Parties to such a contract can anticipate that damages will be easy to assess, because the homeowner will provide proof of stolen property. There is, however, the risk that questions surrounding mitigation will consume resources.<sup>27</sup> For instance, the alarm company can argue that even though it is strictly liable for nonperformance, the property owner has the obligation to mitigate, or at least not to be contributorily negligent; in the extreme, the homeowner cannot possibly collect if he or she gave information to the thief and enabled the crime. It is easy to imagine litigation over less dramatic contributions to the loss—and the parties might sensibly choose to stipulate in order to avoid such litigation.

These unbundled cases, where stipulation is responsive either to the parties' superior ability to assess damages or to the difficulty of evaluating mitigation efforts in court, are relatively rare. When the amount of expectancy damages is hard to assess it will often be the case that both are difficult to evaluate, if only because knowledge and mitigation are intertwined. A common example is that of a product sold with a repair-or-replace warranty, or stipulation. Imagine that a photographer, *P*, purchases a camera made by *N*, offered with just such a warranty, and that *P* suffers losses when the unit malfunctions. Stipulation makes sense because damages can be quite difficult to assess even ex post, and since they take the form of a

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25. 764 P.2d 149 (Okla. 1988). A well known outlier is *Samson Sales, Inc. v. Honeywell, Inc.*, 465 N.E.2d 392 (Ohio 1984), where a similar liquidated damages clause was thrown out as a penalty, both because it was not a reasonable estimate of damages and because damages would normally be easy to ascertain. The parties' language was perhaps unfortunate, and the court might have treated the clause differently had it been fashioned as a limitation on liability. *Fretwell* also raises the issue of a clause fashioned as liquidated damages, but treated by the court as involving a limitation on liability, and therefore not subject to the claim that it was an inapt estimate of damages.

26. *Fretwell*, 764 P.2d at 150.

27. Some readers will be satisfied with the extant explanation and require neither knowledge nor mitigation to do any of the heavy lifting in these cases. For example, causation may be an issue because the crime might have been completed before a response team could have reached the site. Alternatively, the parties might agree on zero damages because the homeowner is normally insured. Finally, they may sense that, without the limitation, it will be too difficult to price the security services ex ante, and a kind of adverse selection will drive the price too high. For more on the underliquidation concern, see generally Warren, *supra* note 5.

limitation on damages, they do encourage some mitigation on *P*'s part. For instance, *P* might travel with a backup camera. There may be no incentive for *N* to mitigate, but in most cases there is little *N* can do by way of mitigation.<sup>28</sup> *P*'s mitigation will not completely eliminate the damages *P* suffers, but these damages are difficult to assess.

I do not mean to say that stipulation is always encouraged by courts or desirable for parties. First, there are cases where ex post determination is easy, as when there is the failure to deliver or to purchase a widely sold commodity, and where ex ante stipulation is more difficult or would simply be deflected to an insurance contract. It happens that in these cases the task of mitigation is easily allocated by contract or by default, so stipulation would sacrifice little on that front, but stipulation is simply not needed in the first place because the amount of expectancy damages is easily assessed. Second, there are cases where the ability of courts to modulate damages in the manner of comparative fault with respect to mitigation (or breach itself) is palpably valuable because both parties may contribute to the delay, or other breach. The parties may choose to stipulate in these settings, and to sacrifice this benefit, but then they need to make their intentions clear. If their underliquidation or overliquidation is too serious, we know that courts may think they erred too much. A straightforward way to think about this is not to emphasize what courts think or encourage, but rather to understand parties as sometimes choosing super-strict liability for themselves.

### C. Stipulation Through the Lens of Mitigation

The arguments advanced here are largely positive in nature, for I do not make a claim as to when courts ought to encourage stipulation. A normative argument would require some confidence in our ability to estimate the costs of determining fault and the costs suffered by encouraging a remedy, stipulated damages, that is more difficult to modulate according to the relative fault of the parties. The positive-normative line would be blurred somewhat if there were more obvious patterns with respect to courts' disregarding stipulated damages or with regard to their encouraging stipulation by denying expectancy damages. But the denials do not seem linked to the breacher's wrongdoing, willfulness, or opportunistic behavior;<sup>29</sup> they do not seem tied

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28. If some disclosure by *N* would be useful, as when *N* learns of a problem from other users, it is possible that the contract or legislation will step in to encourage disclosure, or mitigation. Moreover, where damages include personal injury, as is the case where automobile and pharmaceutical manufacturers could provide notice of dangers, stipulation is likely to fail in the first place.

29. Thus, stipulated damages are often struck as penalties where there is no opportunism, perhaps because the clause makes no attempt to anticipate actual damages, and also where there is objectionable behavior. *See Phillips v. Phillips*, 820 S.W.2d 785 (Tex. 1991) (holding serious breach of fiduciary duty as breach of contract, but finding stipulated damages excessive compared to actual losses). At the same time, stipulated damages are often accepted even where there is opportunism. *See, e.g., N. Ill. Gas Co. v. Energy Coop.*, 461 N.E.2d 1049 (Ill. App. Ct. 1984) (holding that a petroleum ether supplier could collect no more than the stipulated damages after its gas company customer opportunistically terminated the contract).

to the identity of the claimant;<sup>30</sup> and they do not come more readily when the stipulation is customized or boilerplate.<sup>31</sup> The argument advanced here is thus cast as a positive one, explaining repair-or-replace clauses and a variety of other cases as we have seen.

Consider, finally, everyday cases where the conventional rules of contract remedies appear to be ignored. *R* orders a taxi from *T* in order to travel to an airport. If *T* fails to materialize as agreed upon, and *R* loses the value of a nonrefundable ticket (as could have been well anticipated by *T*), we do not expect *R* to recover these expected damages from *T*. Symmetrically, if *T* appears at *R*'s door and *R* had accepted a ride with a friend, *T* may have lost other business, but does not expect to collect from *R*, unless damages were stipulated. In some sense the case is mysterious; it is almost as if all we read in contract treatises has no application in the real world. After all, the damages here are not particularly difficult to determine *ex post*, so that stipulation does not seem superior to expectancy damages on the usual grounds. We might imagine highlighting the nonspeculative costs associated with taking a later flight, and *T* pointing to its wasted time because of *R*'s breach, in hopes of recovering at an hourly rate. But the case can be described neither as one of strict liability for failure to perform nor as one reflecting the imposition of fault or comparative fault. Even if *R* could easily have called *T* to cancel the trip, or *T* could have contacted *R* two hours in advance to encourage *R* to find another means of transport to the airport, we know that, in the absence of stipulation, no damages will be paid for the failure to take these steps. While at first glance this might seem like the wrong result, the picture is easier to rationalize once we bring mitigation into play. It would be hard to know how easy it really would have been for *R* to rush to the airport by another means, or for *T* to find other business.<sup>32</sup> We

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30. *Compare* Farmers Union Grain Terminal Ass'n v. Nelson, 223 N.W.2d 494 (N.D. 1974) (holding that the breaching party is permitted to invoke the stipulated-damages clause as damage limitation), with Carolinas Cotton Growers Ass'n v. Arnette, 371 F. Supp. 65 (D.S.C. 1974) (holding that the breaching party is not permitted to limit its liability to the stipulated-damages clause under similar circumstances); *compare also* Margaret H. Wayne Trust v. Lipsky, 846 P.2d 904 (Idaho 1993) (permitting breachee to seek damages in excess of the stipulated amount), with J. D. Pavlak, Ltd. v. William Davies Co., 351 N.E.2d 243 (Ill. App. Ct. 1976) (limiting breachee's damages to the stipulated amount). *Arrowhead School District No. 75, Park County v. Klyap*, 79 P.3d 250 (Mont. 2003) is an especially convenient case, as there is opportunity for joint mitigation, and enforcement against the breaching party. The contract stipulated damages equal to twenty percent of a teacher's annual compensation. The breaching party resigned just two weeks before the start of the academic year. A replacement teacher was found at a slightly lower salary, but with some effort and of quality not easily measured.

31. Thus, a repair-or-replace remedy for a defective product is normally upheld. *See, e.g.*, Posttapp Assoc. v. Eastman Kodak Co., 537 F.2d 751 (3d Cir. 1976). But often so are earnest money agreements in real estate transactions, customized as they may be. *See, e.g.*, United States v. Ponnappula, 246 F.3d 576, 580 (6th Cir. 2001). *But see* Weber v. Rivera, 841 P.2d 534 (Mont. 1992) (refusing to enforce the clause in a real-estate sales form contract requiring the defaulting party to pay ten percent of purchase price).

32. There is the question of why it is so rare to see parties to this kind of contract agree upon stipulated damages. We do see some expensive restaurants asking for credit card information when taking reservations, and then imposing a stipulated fee for the patron's failure to materialize. Even if the taxi company stipulates *X* dollars for *R*'s failure to wait, *R* may breach either because the alternative ride is free or because *R* fears missing a flight. And if *Y* dollars is stipulated for *T*'s failure to

might think of customary law as offering a default stipulation of zero damages, so that the parties need not litigate the facts of mitigation.

#### CONCLUSION

As a normative matter there is something to be said for complete freedom of contract. From this position it is easy to rail against cases that do not enforce the parties' stipulations, and then to complain also about cases that do not provide expectancy damages, or another remedy, where the parties appear to have planned on the supply of the given remedy. On the other hand, over- and underliquidation can cause inefficiencies that parties may not have anticipated, and these may be avoided if courts judiciously intervene to prevent palpable waste. To this calculus we must now add the idea that just as parties might sometimes wish to avoid a court's assessment of expectancy damages, so too they might sometimes choose to avoid a court's assessment of their mitigation efforts. Stipulation in various currencies thus produces super-strict liability in contract law. It does so by adding strict liability regarding mitigation to the usual strict liability as to the fact of breach. Where mitigation is important, contract law is a comparative-fault regime, and its strict liability component fades in the background. In an important subset of these cases, the parties will prefer strict liability and they will stipulate damages—sometimes partial and sometimes a good estimate of full-expectancy damages—in order to achieve this result. In another subset, they will count on courts to police their efforts in comparative-fault fashion. And in a surprisingly significant third group of cases, they will not stipulate, even knowing that courts will decline to impose liability.

The other reconception suggested here, that contract law effectively encourages the stipulation of damages, is a weaker though more startling claim. The doctrinal knowledge of most lawyers is, after all, limited in this regard to the fact that one must be careful not to overliquidate and enter the realm of penalty damages. But as we look at the variety of cases, it is apparent that the presumed remedy of expectancy damages is disrespected by courts at least as much as the contractual provision of stipulated damages. And inasmuch as the remedy of expectancy damages is still available when a penalty damage term is disregarded, there will be many circumstances in which parties will do well to stipulate damages. Certainly, such stipulation does sometimes introduce the problem of an insufficient incentive to mitigate, especially when mitigation requires joint effort, but this problem can

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pick up *R* as promised, *T* will still breach if another customer, *S*, pays a sufficiently higher price—though we have no reason to think that *S* values the ride more than *R*, whose fare was likely determined by a fixed schedule. But bargaining can encourage earlier transmittal of information. It might pay for *R* to stipulate that “I will pay you fifty dollars if I am a no-show, but only thirty dollars if I give more than one-hour notice.” Similarly, we do find restaurants excusing the penalty with enough notice. But it is also possible that we do not often find more detailed stipulation because such stipulation might be thought to encourage breach, as it offers a price for breach. See Uri Gneezy & Aldo Rustichini, *A Fine Is a Price*, 29 J. LEGAL STUD. 1 (2000) (finding that charges, or fines, at least within limits, increased rather than decreased late pickups at daycare centers). Still, at the right price, breach ought to be welcome. Some restaurants and airlines do seem comfortable with no-shows, once fees have been included.

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be reduced with yet more detailed stipulation. Courts may want to take these points into account when striking or enforcing stipulated-damage clauses and when adjudicating mitigation disputes. As is often the case, a positive theory of the behavior of parties and courts is likely to bear on the normative questions associated with legal rules and private practices.

