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## Remedies and the CISG: Another Perspective

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### Abstract

In this brief comment, I apply behavioral decision theory to the question of the enforcement in transnational sales of super-compensatory agreed damages. I conclude that a good case can be made that such damages provisions should be enforced.

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Professor Katz evaluates the remedial rules of the Convention on International Sale of Goods (CISG) from an economic perspective. He identifies high transportation, communication, monitoring, and adjudication costs as distinct characteristics of international sales, identifies optimal rules to regulate such transactions, and compares these rules to CISG. Although international sales are not homogenous and technological advances may change their nature,<sup>2</sup> Katz's model allows him to evaluate what is currently a critical mass of these transactions.

In this brief comment, I adopt Katz's assumptions about the nature of international sales, and focus on one of Katz's topics, namely agreed damages.<sup>3</sup> However, my frame of reference

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<sup>1</sup> I presented this comment at the NYU Conference on "Commercial Law Theory and the CISG," at the Villa LaPietra, Florence, Italy, 16 October 2004.

<sup>2</sup> A participant at the NYU conference pointed out, for example, that not all international sales are long distance. Consider a merchant in eastern France that sells goods to a neighbor in western Belgium. Further, Professor Katz himself observes that new technologies, such as electronic contracting, may change the nature of international sales. In addition, sellers and buyers often rely on long-term distributorship agreements in international sales, which also challenges some of Katz's assumptions about the nature of international sales.

<sup>3</sup> Katz discusses the "two waves" of economic analysis of agreed damages that conflict over the enforcement of super-compensatory (greater than expectancy) damages. The first wave supported the common law's reticence

is behavioral decision theory (BDT). BDT examines people's methods of using information and strategies for making choices. The discipline focuses on people's limited capacity to gather and process information, and their use of mental shortcuts (heuristics) and biases in decision-making.<sup>4</sup> I am interested in what the discipline suggests about the enforcement in transnational sales of super-compensatory (greater than expectancy) agreed damages, generally called "penalties" in US domestic transactions, and the subject of judicial animosity here. A good argument can be made that whatever the validity of the US approach, super-compensatory damages should be enforceable in the international arena, an approach that CISG arguably leaves room to adopt.<sup>5</sup>

Super-compensatory agreed damages may serve at least the following purposes in sales transactions. First, such damages create incentives for sellers and buyers to perform, thereby reducing the likelihood of breakdown and all of its associated costs.<sup>6</sup> By creating incentives to perform, super-compensatory damages also reduce monitoring costs and encourage difficult-to-prove reliance on the contract.<sup>7</sup> When a deal does breakdown, super-compensatory damages, eliminate the expense of litigating the amount of actual damages.<sup>8</sup> Further, as Professor Katz points out, "parties choose among remedial terms and trade them off against more traditional [ones] to suit joint interests."<sup>9</sup> Why should super-compensatory damages be treated differently? In fact, viewed in this light, enforcing a super-compensatory damages clause is what the parties should expect.

Notwithstanding these arguments, courts in the US fail to enforce agreed damages when they are not commensurate with a party's lost expectancy. Part of the reason is simply contract law's historical aversion to penalties,<sup>10</sup> but courts and scholars offer additional explanations based on their belief that parties fail to bargain over these clauses. Many of these explanations anticipate BDT insights.<sup>11</sup>

Courts and writers maintain, for example, that parties agree to super-compensatory damages because they are too optimistic that nothing will go wrong.<sup>12</sup> BDT supports this assumption by observing an overconfidence bias in people, who are willing to accept too much risk because they believe that adverse low-probability risks will not occur. In addition, analysts assert that parties do not understand and process the ramifications of breach,

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to enforce such "penalty" provisions, largely because enforcement would deter efficient breach. The second wave reverses that position in part because courts "mistakenly characterized damages as excessively penal when a fuller economic understanding would have revealed them as merely compensatory." Katz characterizes CISG as "anticipating" the second wave. However, CISG's approach is problematic. See *infra* notes 24–29, and accompanying text.

<sup>4</sup> See, e.g. Robert A. Hillman, *The Limits of Behavioral Decision Theory in Legal Analysis: The Case of Liquidated Damages*, 85 *Cornell L. Rev.* 717 (2000), and authorities cited therein.

<sup>5</sup> See *infra* notes 24–29, and accompanying text.

<sup>6</sup> See Hillman, *supra* note 4, at 725.

<sup>7</sup> Katz makes this point.

<sup>8</sup> Hillman, *supra* note 4, at 725.

<sup>9</sup> Katz, *Remedies for breach of contract under the CISG*. *International Review of Law and Economics*, 25, 378–396.

<sup>10</sup> E. Allan Farnsworth, *Contracts* 842 (3d. ed. 1999).

<sup>11</sup> See Melvin Eisenberg, *The Limits of Cognition and the Limits of Contract*, 47 *Stan. L. Rev.* 211 (1995).

<sup>12</sup> Hillman, *supra* note 4, at 727.

and therefore do not understand the import of a super-compensatory damages clause.<sup>13</sup> BDT's identification of people's general limited capacity to absorb and process information ("bounded rationality") supports this conclusion.<sup>14</sup> Courts are may also be reluctant to enforce super-compensatory damages because they believe that parties, already invested in a relation, seek to suppress information that raises the specter of breach, a subject that makes them uncomfortable.<sup>15</sup> BDT's observation that people generally stifle information that makes them feel insecure ("cognitive dissonance"), supports this insight too.<sup>16</sup>

In the transnational setting, the factors that may help explain the judicial reluctance to enforce super-compensatory damages provisions may be less significant. Assuming that international sales are characterized by high monitoring, breakdown, litigation and collection costs,<sup>17</sup> the parties may be less optimistic about the success of their venture and pay greater attention to their remedies.<sup>18</sup> Parties who comprehend the importance of remedial clauses also devote more of their limited resources to understanding the terms and their ramifications. In addition, the potential high costs of breakdown may outweigh the urge to suppress its uncomfortable possibility. In short, Katz's conclusion that agreed damages clauses are no different from other terms and are subject to trades is more likely true in the international arena.

Obviously, this analysis only scratches the surface of the insights BDT may bring to bear on super-compensatory damages. On the other hand, significant questions about the usefulness of such an analysis remain. Do behavioral observations in the laboratory apply to merchants engaged in international sales?<sup>19</sup> Is the science sufficiently sophisticated to discern from the plethora of observations about decision-making those applicable in particular settings?<sup>20</sup> Should the law accommodate cognitive deficiencies or seek to change behavior?<sup>21</sup> Do business managers learn to avoid sub-optimal decision-making in the face of elimination from the marketplace?<sup>22</sup>

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<sup>13</sup> Eisenberg, *supra* note 11, at 227.

<sup>14</sup> *Id.*

<sup>15</sup> Hillman, *supra* note 4, at 731.

<sup>16</sup> *Id.* at 724–725.

<sup>17</sup> The use of third-party guaranty devices such as letters of credit evidence parties' concern with these matters. See Katz, *this issue*.

<sup>18</sup> Simply put, the extra costs of breakdown and collecting judgments may outweigh the tendency to be too optimistic.

<sup>19</sup> See, e.g., Hillman, *supra* note 4, at 730.

<sup>20</sup> *Id.*

<sup>21</sup> *Id.* at 733.

<sup>22</sup> Businesses probably make cognitive errors too. See, e.g., Avishalom Tor, *The Fable of Entry Bounded Rationality, Market Discipline, and Legal Policy*, 101 *Mich. L. Rev.* 482, 561–62 (2002) ("[T]raditional economists argue that because in markets decision-makers pay a price for their mistakes they learn and correct their errors. The learning argument assumes, however, that decision-makers are able to identify their mistakes, associate them with the costs they incur and proceed to correct them. These assumptions are rarely met either in the case of entry or in other legally significant real-world settings."); Max Bazerman, *Judgment in Managerial Decision Making* 5 (4th ed., 1998). (Since managers make hundreds of decisions daily, the systematic and time-consuming demands of rational decision making are simply not viable. . .); Mark A. Lemley & Lawrence Lessig, *The End of End-to-End Preserving the Architecture of the Internet in the Broadband Era*, 48 *UCLA L. Rev.* 925, 950 (2001) ("the uncertainty and pressure from business competitors and rapid technological change has led executives to

To the extent that BDT does bear fruit, it suggests the enforcement of super-compensatory damages in international sales. This reinforces Katz's similar conclusion reached on the basis of his economic analysis.<sup>23</sup> CISG's treatment of such clauses, unfortunately, is not clear. No specific provision speaks to the question. As Professor Katz points out, however, Article 6, which grants the parties freedom of contract, suggests that parties can trump CISG's remedial default rules, which provide for expectancy damages.<sup>24</sup> However, Article 4 recites that questions of "validity" are left to applicable domestic law.<sup>25</sup> "Validity," left undefined by CISG, appears to involve issues such as duress, unconscionability, and misrepresentation.<sup>26</sup> If enforcement of super-compensatory damages is a validity question and the applicable domestic law is UCC section 2-718, for example, a super-compensatory damages provision would be unenforceable.<sup>27</sup>

An argument can be made that Articles 6 and 4 allow for the enforcement of super-compensatory damages even when UCC section 2-718 is the local law because such damages do not involve a validity question under CISG. For one thing, the special tests of UCC section 2-718 do not focus on questions such as duress, misrepresentation, and unconscionability, but on "the anticipated or actual harm caused by the breach," and the problems of proving the loss.<sup>28</sup> For another, if merchants in international sales do not lose sight of agreed remedies provisions and bargain and trade them off against other provisions in relatively fair bargaining power situations, super-compensatory damages terms simply do not raise validity questions. In addition, Article 7 admonishes courts to interpret contracts mindful of their "international character" and to "promote uniformity."<sup>29</sup> Deference to local law obviously would defeat those purposes. On the other hand, Section 2-718 also states that "[a] term fixing unreasonably large liquidated damages is void as a penalty." Such a mandatory term, however, potentially wrong-headed in the international sales context, leaves little room for the argument that Article 4 does not apply, unless courts read "unreasonably large" as not capturing all agreed damages provisions that exceed expectancy.

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enter into mega-mergers on the basis of the kind of decision-making biases that, according to behavioral and psychological research, are typical of human beings reacting in the face of complexity and uncertainty,") citing James A. Fanto, *Braking the Merger Momentum: Reforming Corporate Law Governing Mega-Mergers*, 49 *Buff. L. Rev.* 249, 288–89 (2001). See also Robert Prentice, *Enron: A Brief Behavioral Autopsy*, 40 *Am. Bus. L. J.* 417 (2003).

<sup>23</sup> Katz relies on the "practical inadequacy of expectation damages," and the "difficulties of collecting monetary judgments in transnational settings," in concluding that the law should have a "more liberal attitude toward super-compensatory damages" in the international sales setting.

<sup>24</sup> Katz, *Remedies for breach of contract under the CISG*, *International Review of Law and Economics*, 25, 378–396.

<sup>25</sup> See, e.g. Peter A. Piliounis, *The Remedies of Specific Performance, Price Reduction and Additional Time (Nachfrist) Under the CISG: Are These Worthwhile Changes or Additions to Sales Law*, 12 *Pace Int'l L. Rev.* 1 (2000).

<sup>26</sup> See Harry M. Flechtner, *Remedies Under the New International Sales Convention: The Perspective from Article 2 of the U.C.C.*, 8 *J. L. & Com.* 53, 79–80 (1988).

<sup>27</sup> UCC 2-718(1).

<sup>28</sup> *Id.*

<sup>29</sup> See Phanesh Koneru, *The International Interpretation of the UN Convention on Contracts for the International Sale of Goods: An Approach Based on General Principles*, 6 *Minn. J. Global Trade* 105 (1997).