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EFFICIENT PENALTY CLAUSES WITH DEBIASING: LESSONS FROM COGNITIVE PSYCHOLOGY

Enrico Baffi

I. INTRODUCTION

The rules that apply to liquidated damages partially diverge between the common law and civil law tradition. In the United States, a distinction arises between a “proper” liquidated damages clause and a penalty clause. A provision determining the amount of damages that must be awarded in the event of breach is considered a “liquidated damages provision” and is enforceable under two conditions: (1) the actual damages at the time of contracting were difficult to estimate; and (2) the amount fixed in the provision is a reasonable estimate of the actual loss. When these two conditions do not hold, the clause is considered a penalty clause and is void. Richard Posner has described this distinction as “a major unexplained puzzle in the economic theory of the common law.” Scholars who make use of rational choice theory find this doctrine inefficient and unjustified, although their position is warranted because of their respect for the common law efficiency hypothesis.

This common law treatment of penalty clauses reveals that U.S. courts do not fully share the idea that humans are perfectly rational decision makers. Indeed, U.S. courts justify the invalidation of penalty clauses by referring to the “illusions of hope,” i.e., the confidence that nothing will go wrong. Courts consequently assume that due to their
optimism, parties “fail to bargain adequately over remedial provisions.”
In cognitive psychology terminology, this “unrealistic optimism” is
referred to by courts as “overoptimism,” “overconfidence,” or “the
illusion of control.” The reasonableness evaluation of liquidated
damages is normally carried out from an ex ante point of view, but in
some cases courts have preferred a so-called “second-look standard,”
that is, a comparison between the predetermined damages and actual
damages. In the United States, this tendency has been approved by
some influential scholars. In civil law countries there has been no such
strong opposition to penalty clauses; general civil law systems follow an
intermediate approach, as exemplified by the Italian Civil Code of 1942,
which states in Article 1382 that “the penalty may be reduced if . . . its
amount is manifestly too high.”

II. HYPOTHESES CONSIDERED

In this work, we shall review damages provisions that would be
considered penalty clauses according to U.S. common law (i.e., because
they are not a reasonable estimate of damages) and should be reduced,
according to civil codes, as disproportionately high. The aim of this
Article is to use cognitive psychology to identify cases in which penalty
clauses should be considered enforceable in the presence of the
previously described conditions. This should allow for the evaluation
and scrutiny of the liquidated damages provision in both common law
and civil law jurisdictions. Prominent scholars have previously

7 Robert A. Hillman, The Limits of Behavioral Decision Theory in Legal Analysis: The Case of
8 See, e.g., Hutchison v. Tompkins, 259 So.2d 129, 131–32 ( Fla. 1972) (explaining that in
evaluating liquidated damages clauses, courts usually consider the circumstances leading
up to the drafting of the liquidated damages clause).
9 This expression is used by Melvin Aron Eisenberg, The Limits of Cognition and the
10 Id. at 235 & nn.119 & 120.
11 Codice civile [C.c.] art. 1384 (It.), translated in Italian Codice Civile, TRANS-LEX.ORG,
http://www.trans-lex.org/601300 (last visited June 29, 2013) (translated by author). There
are however several differences among civil law systems. For example, in Germany and
only in Germany there is a distinction for merchants’ discipline as opposed to one for non-
merchants. In Germany, the distinction is drawn between the civil code and the
commercial code. Whereas the latter considers enforceable penalty clauses, BGB section
343 states, “If a payable penalty is disproportionately high, it may on the application of the
obligor be reduced to a reasonable amount by judicial decision.” Bürgerliches Gesetzbuch
[BGB] [Civil Code]. Jan. 2, 2002, Reichsgesetzbuch [RGBl] at 64, as amended § 343, ¶ 1,
sentence 1 (Ger.). See generally Ugo Mattei, The Comparative Law and Economics of Penalty
Clauses in Contracts, 43 AM. J. COMP. L. 427 (1995) (relaying the general situation in
Continental Europe).
addressed this issue through the lens of cognitive psychology, but I hope to shed some new light on this issue within the framework of analysis of this discipline.

As a benchmark case, we will consider whether (and why) two perfectly competent parties would introduce a liquidated damages provision that is not a reasonable estimate of expected damages. Influential scholars have reached different conclusions on this very question. Samuel Rea and Alan Schwartz suggested that a supra-compensatory damage provision is inefficient, while Anthony Kronman and especially Richard Posner have espoused the opposite claim. According to Rea, “There are no strong economic arguments for enforcing damages that are unreasonably large ex ante, and the doctrine can be justified as a method of identifying cases of mistake or unconscionability.” In the language of the unconscionability doctrine, substantive unconscionability is evidence of procedural unconscionability. To the contrary, Posner affirms the idea that penalty clauses can be useful as a signal for a promisor’s reliability. According to Posner, this signaling function is important especially for new entrants in the market who have not yet built up a reputation. An effective way for a promisor to convince other parties that he will perform as promised is to offer a penalty clause against himself. The fact that the promisor is willing to offer such a heavy sanction on his non-performance is a signal that he is convinced that he is willing and able to perform. Thus a penalty clause has a communicative function: it is a signal of reliability sent by the party to the contract who does not have a clear positive reputation in the market because he is a new entrant.

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15 Rea, supra note 13, at 167. Rea’s idea is that a supra-compensatory provision is a form of gambling that is not desirable for parties who are risk-averse. The premium requested by one party exceeds the benefit obtained by the other party. Id.
17 RICHARD POSNER, ECONOMIC ANALYSIS OF LAW 142 (5th ed., 1998).
III. COGNITIVE PSYCHOLOGY, PENALTY CLAUSES, AND THE ROLE OF THE COURTS

Cognitive psychology refutes the idea of the rational human decision maker.\textsuperscript{18} Decision makers use heuristics and often commit systematic mistakes.\textsuperscript{19} “Bias” is the term used to indicate the observed behavioral gap between the rational human choice and the real-life individual observed in the experiments.\textsuperscript{20} The ideal competence that Posner attributes to the decision maker is at odds with the findings of cognitive psychology. At first glance, cognitive psychology should offer arguments for those who approve the penalty doctrine; however, if we consider that one of the most important biases that has been singled out, overoptimism, seems to be the scientific elaboration of the illusion of hope idea, it is apparent that this has been used by some courts to justify the penalty doctrine.\textsuperscript{21}

However, some problems immediately arise. First of all, scholars who suppose that judges can establish whether the ex ante evaluation of damages was reasonable probably consider this task too easy. Here, as Hillman suggests, cognitive psychology offers some arguments to those who are skeptical about the capabilities of judges to elaborate on this judgment.\textsuperscript{22} Hindsight bias, another systematic deviation from rational behavior, can also be a problem for judges. This bias consists of the assumption that people overstate the “predictability of events.”\textsuperscript{23} Once

\textsuperscript{18} See Nancy Levit, Confronting Conventional Thinking: The Heuristics Problem in Feminist Legal Theory, 28 CARDOZO L. REV. 391, 406 (2006) (“[Cognitive psychology] means that people will make decisions that are not consistently ‘rational’ in the logical-evidentiary sense—decisions that, in the words of law and economics, ‘fail to maximize their expected utility.’”) (footnote omitted).

\textsuperscript{19} See Amir N. Licht, The Maximands of Corporate Governance: A Theory of Values and Cognitive Style, 20 DEL. J. CORP. L. 642, 670 (2004) (“Research in another field of psychology, judgment and decision making, may be helpful in identifying the factors that influence this variation. The pivotal observation here is that cognitive processes are taxing for individuals. This is strongly evidenced by the phenomenon of cognitive heuristics, which allow for fast and frugal reasoning albeit at the price of systematic errors.”) (footnote omitted); see also Sarah Thimsen, Brian H. Bornstein & Monica K. Miller, The Dynamite Charge: Too Explosive for Its Own Good?, 44 VAL. U. L. REV. 93, 114–118 (2009) (analyzing the implementation of heuristics by jurors and the dangers presented).

\textsuperscript{20} See Donald C. Langevoort, The SEC, Retail Investors, and the Institutionalization of the Securities Markets, 95 VA. L. REV. 1025, 1043–44 (2009) (“[Heuristics and Biases] are simply ways of thinking and deciding that appear in laboratory experiments and field studies with statistically significant frequency.”).

\textsuperscript{21} See Hillman, supra note 7, at 728 (explaining that the optimism of performance taints the parties’ evaluation of whether to include a liquid damages provision).

\textsuperscript{22} Id. at 728–29.

people know that an event has happened, “they believe it was more likely to occur than before they received the information.”

Judges can also exhibit hindsight bias and overestimate a party’s ability to calculate, when they have stipulated the contract, the damage that could result from a breach. If, for example, there were a one percent possibility that substantial damage would occur in the case of breach and then that event actually occurred, the hindsight bias could lead the judge to think that there was a twenty percent chance. In this way cognitive psychology can offer arguments to sustain the opinion of the difficulty of a judgment about the ex ante reasonableness of damages, supporting the idea that liquidated damages provisions should not be subjected to rigid scrutiny.

Second, judges’ sense of fairness may cause them to void a damages provision simply because actual damages turn out to be inconsistent with the agreed upon damages—a tendency that has already emerged in some Anglo-American decisions. Finally, cognitive psychology can invite legislators to be cautious about judges’ ability to evaluate damages clauses because of the presence of the “framing effect.” The “framing effect” is a bias consisting of systematic reversals of preferences when the same problem is presented in different ways. In the context of the damages provision, the framing effect can be quite evident; indeed, parties can frame a penalty clause in such a way that judges evaluate it as such. Parties can frame their agreed damages clause so that a judge is unlikely to call it a penalty. For example, a seller can essentially achieve the same result by either offering a discount for early payment or a penalty for late payment. “The ease with which parties can manipulate their agreed remedies provision suggests that the dichotomy between penalties and liquidated damages lacks substance, and simply results from a framing bias of judges.”

As far as cognitive deficiencies that can influence judges are concerned, Jeffrey Rachlinski has observed, “[C]ourts might already have reduced the effect of hindsight bias . . . by identifying

24 Hillman, supra note 7, at 723.
27 Hillman, supra note 7, at 736.
29 Hillman, supra note 7, at 733.
circumstances in which actual damages are considered per se unpredictable.”30 Rachlinski’s idea is that judges’ biases can be corrected in the same way as biases of every person can be eliminated.31 It is merely a problem of building a system of rules that work in that direction.32

IV. THE FIELD OF BIASES: OVEROPTIMISM, OVERCONFIDENCE, AND THE ILLUSION OF CONTROL

Arguments have been extrapolated from cognitive psychology that suggest the inefficiency of the penalty doctrine because of biases that can affect the courts. However, cognitive psychology, given its nature as a discipline that denies individual rationality, is usually a fertile ground for proponents of a more stringent control of contracts—in other words, for a wider legal paternalism. For purposes of this topic, three biases shed light on our discussion, as already anticipated: overoptimism, overconfidence, and the illusion of control.33

31 Id.
32 See id. at 757 (“[B]ecause people and institutions can adapt to their cognitive limitations, a clear rule of enforcing liquidated damages clauses could lead experienced parties to develop an appropriate adaptation.”) (footnote omitted).
33 See generally Neil D. Weinstein, Optimistic Biases About Personal Risks, 246 SCIENCE 1232 (1989) [hereinafter Weinstein, Optimistic Biases]; Neil D. Weinstein, Unrealistic Optimism About Susceptibility to Health Problems: Conclusions from a Community-Wide Sample, 5 J. BEHAVIORAL MED. 481 (1987); Neil D. Weinstein, Unrealistic Optimism About Future Life Events, 39 J. PERSONALITY & SOC. PSYCHOL. 806 (1980). In these works, Neil Weinstein gives some particularly important data on overoptimism with regard to personal safety. In general, an individual will consider herself less at risk than others. However, Weinstein also highlights the fact that “[o]ptim[is]m biases also appear for positive events: people regard themselves as more likely than others to experience financial success, career advancement, and long life.” Weinstein, Optimistic Biases, supra, at 1232. Weinstein states, “In general, optimism is greatest for hazards with which subjects have little personal experience, for hazards rated low in probability, and for hazards judged to be controllable by personal action.” Id. The author considers experience to be a significant factor, a theme which is not given much emphasis in this Article, but he also attaches importance to forms of illusion of control, a typical characteristic of the counterparty who believes he has all aspects of a contract under control. From this point of view, Weinstein’s work is instructive in terms of demonstrating the results which can be achieved in this Article. See generally Lynn A. Baker & Robert E. Emery, When Every Relationship Is Above Average: Perceptions and Expectations of Divorce at the Time of Marriage, 17 L. & HUM. BEHAVIOR 439 (1993) (concluding that a more accurate knowledge of the type of event and its consequences does not correct the bias); Arnold C. Cooper, Carolyn Y. Woo & William C. Dunkelberg, Entrepreneurs’ Perceived Chances for Success, 5 J. BUSINESS VENTURING 97, 107 (1988) (suggesting that entrepreneurs should form relationships with outsiders, such as board members, other business people, and accountants, who can provide objective assessments); Dan Lovallo & Daniel Kahneman,
A. Overoptimism

Overoptimism bias is the systematic tendency for people to be overly optimistic about planned actions. More precisely, it is a tendency to overestimate the likelihood of good things happening regarding the outcome of planned actions and other events. A random study of New Jersey adults showed a high overoptimism regarding personal risks. In general, optimism is greatest for hazards judged to be controllable by personal actions. “A significant optimistic bias was found for 25 of 32 hazards in this study.” People are unrealistically optimistic in relation to many aspects of their lives. The majority of people “believe that their own risk of a negative outcome is far lower than the average person’s.”

Its relevance here is patent. If decision makers are unrealistically optimistic, they will systematically underestimate risks so that they will not understand the exact probability they face to pay damages stated by the penalty clause. If the parties to an agreement underestimate the risk of breach, then they assign it too low a value and are prone (if we

35 See Hillman, supra note 7, at 723 (explaining the tendency for people to be overconfident). “Once people make a decision, they are especially likely to downplay risks and to become overconfident about their decisions.” Id. (footnotes omitted).
36 Weinstein, Optimistic Biases, supra note 33, at 1232.
37 Id.
38 Id.
39 There is evidence that people underestimate their absolute as well as relative probability of auto accidents. See Colin F. Camerer & Howard Kunreuther, Decision Processes for Low Probability Events: Policy Implications, 8 J. POL'Y ANALYSIS & MGMT. 565, 566 (1989) (“For example, motorists perceive their chances of suffering a severe accident as very low, even though the data show that cars are one of the leading causes of death in the U.S. (over 47,000 deaths in 1986.”).
41 Lovallo & Kahneman, supra note 33, at 58 (“When forecasting the outcomes of risky projects, executives all too easily fall victim to what psychologists call the planning fallacy. In its grip, managers make decisions based on delusional optimism rather than on a rational weighting of gains, losses, and probabilities.”).
imagine that it is rational to introduce a supra-compensatory provision) to provide for too-high damages. A link between overoptimism and overconfidence is represented by evidence that people usually underestimate low-probability risks of economic loss as well as low-probability high-magnitude risks unless they are highly salient.42

B. Overconfidence

Overconfidence is another bias that consists, first of all, of the human tendency to be more confident in one’s behaviors, attributes, and physical characteristics than one ought to be.43 This definition, however, could create some confusion with the other self-serving bias, overoptimism. In cognitive psychology, overconfidence indicates the tendency of subjective accuracy to consistently exceed the objective accuracy of prediction.44 Overconfidence bias may also cause people to persist in situations where their expected outcome is poor. Moreover, overconfidence causes many individuals to grossly underestimate their odds of making a payment late. Statistically, many people are quite likely to make one or more payments late due to a normal range of difficulties and delays in day-to-day life.45 Overconfidence has an important consequence when it is only possible to know the probable distribution of an outcome. In this case, overconfidence determines a tendency to assign too low a variance to the probability distribution; if it is too tight to start with, one is unlikely to optimally evaluate the penalty clause.46

It has been said that

[t]he pervasive finding that subjects are overconfident may have important economic implications. If people underestimate the width of distributions of future quantities, they will underinvest in flexibility and insurance, which might have implications for equilibrium models of rental and ownership of housing, choices of mortgage terms (adjustable vs. fixed-rate),

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43 Briony D. Pulford & Andrew M. Colman, Overconfidence, Base Rates and Outcome Positivity/Negativity of Predicted Events, 87 BRITISH J. PSYCHOL. 431, 431 (1996).
44 Id.
46 See generally JUDGMENT UNDER UNCERTAINTY: HEURISTICS AND BIASES 287 (Daniel Kahneman et al. eds., 1982) (discussing an examination of the results of experiments).
marriage and divorce rates, managerial investments in manufacturing flexibility, and so on. Underestimation of variation might help explain why so many small businesses fail because of insufficient cash flow (stemming from overly narrow planning, perhaps).47

C. The Illusion of Control

The illusion of control is the tendency for individuals to believe they can exercise control over, or at least influence, outcomes over which they have no demonstrable influence.48 This is a particularly important bias for our analysis because parties who mistakenly believe that they can control events with regard to penalty clauses ultimately make the wrong decisions. Literature regarding the illusion of control indicates that entrepreneurs, for example, view risk as a challenge to be overcome and choice as a commitment to a goal.49 They imagine themselves in control of people and events. Many attempts have been made to provide explanations for this bias, some of which view this as a positive adaptive characteristic of human beings. The analysis in this Article, however, outlines the possible wrong decisions that can be brought about by this bias, but not its psychological motivation.

The justification of one important explanation for illusion of control has its roots in the necessity of people to give themselves self-regulation. In a chaotic and unregulated world, people are driven by internal necessities to reassert control.50 Self-serving biases have been considered

50 ELLE J. LANGER, The Illusion of Control, in JUDGMENT UNDER UNCERTAINTY: HEURISTICS AND BIASES, supra note 46, at 231.

While most people will agree that there is much overlap between skill and luck, a full understanding of how inextricability bound the two are has to be attained. In principle the distinction seems clear. In skill situations there is a causal link between behavior and outcome. Thus, success in skill tasks is controllable. Luck, on the other hand, is a fortuitous happening. The issue of present concern is whether or not this distinction is generally recognized. The position taken here is that it is not.

Id. It is conceivable that the illusion of control increases with the desirability of the possible result from a contract, or perhaps with the necessity to draw up a contract, particularly where a potential agreement is seen as essential or highly attractive. This phenomenon is also recognized in the area of overoptimism: the more desirable the
by many scholars as solid justification for the judicial scrutiny of penalty clauses.

V. COGNITIVE PSYCHOLOGY AND PENALTY DOCTRINES

If we consider individuals in terms of cognitive psychology, there are three particular biases that are possible at the point of accepting a contract, which include penalty clauses: (1) overoptimism, which leads the subject to believe the situation is more favorable than it really is; (2) overconfidence, which gives rise to excessive self-belief with regard to evaluating a situation, particularly concerning the likelihood of success (the subject has a high degree of certainty and does not consider the full range of probable outcomes, including those most damaging); and, (3) finally, the illusion of control, which leads the subject to feel that the situation is under control and is only influenced by his/her will, rather than random events.51

These three biases would seem to justify comprehensive checking of penalty clauses due to the possibility of making wrongful choices. By the same token, a number of other checks of contractual freedom could be justified, in the wider context, in any instance where a party voluntarily takes risks.

Cognitive psychology, however, offers a deeper knowledge of cognitive limitations that can prevent a perfectly rational decision. But this discipline is context-specific and rejects some kinds of generalizations that are peculiar to neoclassical economic thought, such as the familiar theory that all human beings, except the underaged and other minor exceptions, are competent individuals.52 Cognitive psychology rejects such generalizations.

potential result, the higher the probability of success which is attributed to achieving it. All these elements influence the biases which can prejudice a decision relating to penalty clauses. See Pulford & Colman, supra note 43, at 437 (“Another judgmental bias that has been reported is a tendency for probability estimates of future events to be unrealistically optimistic, and there is evidence that this bias varies according to whether the prediction is related to positive or negative events . . . .”). Langer’s view in her work on the subject is particularly significant. “In addition . . . there is another reason for this lack of discrimination between controllable and uncontrollable events. This is the fact that skill and chance factors are so closely associated in people’s experience.” LANGER, supra, at 238. This aspect is noteworthy because the risk inherent in court cases, even if low, may depend on a mix of controllable and uncontrollable events and as such may give rise to an illusion of control. As Langer states, “There is often a true difficulty in making the discrimination, since there is an element of chance in every skill situation and an element of skill in every chance situation.” Id. If the overoptimism increases with the desire to close the deal, it may be the case that skill elements appear to outweigh chance elements.

51 See supra Part IV (defining and illustrating these three biases).
52 See Jeffrey J. Rachlinski, The Uncertain Psychological Case for Paternalism, 97 Nw.
For these reasons, it would be desirable that once biases like overoptimism, overconfidence, and the illusion of control have been underlined, then some further distinctions could be traced. It seems doubtful that the same biases affect naive and sophisticated consumers, business people, chief executive officers, and company agents alike.

Melvin Eisenberg has introduced his own proposal for the regulation of penalty clauses. According to Eisenberg, overoptimism, along with other cognitive deficiencies, should justify a discipline of this sort:

If, in the breach scenario that has actually occurred, liquidated damages are significantly disproportional to real losses (that is, losses in fact, not simply legal damages), the provision is unenforceable unless it is established that the parties had a specific and well-thought-through intention that the provision apply in a scenario like the one that actually occurred.53

One supporter of the penalty doctrine is Jeffrey Rachlinski, on the basis of a broad generalization that contracting parties are overly optimistic.54 However, it is evident that these proposals tend to make use of broad generalizations. At first glance, it would seem possible to trace an intuitive distinction between people with some experience in a certain activity (in the case examined in this Article—contracts with a penalty clause) and people without experience. The idea that some biases could be eliminated with experience is very intuitive, first of all because the decision makers usually bear the cost of their wrong decisions, and for this reason they should have an incentive to change their behavior.

Experience should have a strong debiasing effect. In this context, it is worth noting that courts have never introduced a distinction between sophisticated parties, to which the penalty doctrine should not be applied, and naive parties, protected by this doctrine. Courts have anticipated cognitive psychology results, because, contrary to intuition, empirical studies tell us that experience does not eliminate some biases,

53 Eisenberg, supra note 9, at 234–35.
54 See Rachlinski, supra note 30, at 760–63. It is interesting to note that this author in some papers has underlined the tendency of cognitive psychology to avoid generalizations and instead to be characterized by attention to context. See, e.g., Jeffrey J. Rachlinski, Cognitive Errors, Individual Differences, and Paternalism, 73 U. Chi. L. Rev. 207 (2006). However, there may well be a problem of interpretation, since his explanation is, in some respects, a summary rather than a detailed treatment.
particularly those considered here—overoptimism, overconfidence, and the illusion of control.55

More precisely, although experience can work, at least to some degree, it is necessary that some stringent conditions be present. Hence, experiments have shown that feedback must be rapid and accurate.56 Moreover, feedback should regard not only the mere result, but should be “task feedback,” that is, feedback that extends into what was inappropriate and what should have happened.57 With regards to penalty clauses, experience could have an effect because the larger the financial loss, the faster the learning, and in many cases penalty clauses determine substantial financial losses. However, this effect is probably eliminated by the fact that the phenomenon of “learning by experience” works if experience is very frequent, whereas paying liquidated damages is relatively rare for most market participants.58

This unpleasant result prevents the possibility of tracing a distinction between sophisticated parties and naive parties. Using unconscionability doctrine terminology, if the results of cognitive psychology had been different, it would have been possible to construe a lack of sophistication as procedural unconscionability and unreasonableness of the liquidated damages provision as substantive unconscionability.59 In this way, using scientific results based on the typical biases of overoptimism and overconfidence, the penalty doctrine, such as unconscionability, could have been inserted into the traditional doctrines. Furthermore, a method of alleviating the strong scrutiny applied to liquidated damages provisions would have been identified. Unfortunately, it is not possible to further develop the idea of distinguishing between sophisticated and unsophisticated parties.

57 Remus et al., supra note 55, at 23.
58 See Garvin, supra note 25, at 389 (discussing the faulty rationale that availability of information will guarantee rational decision making because “information would be worth less in a world of systematic cognitive error than it would in a world of perfectly processed information”).
59 See Hillman, supra note 7, at 738 (“[P]erhaps courts should abandon the special tests for agreed damages and simply apply traditional policing doctrines, such as unconscionability and duress.”).
VI. NEW DISTINCTIONS, UNSATISFACTORY RESULTS

While having acknowledged that the distinction between sophisticated and unsophisticated parties is not useful, it remains important to explore some of the other arguments outlined above. Among such arguments supporting penalty doctrine, we mentioned those suggesting that individuals are overly optimistic and overconfident and that they do not accurately evaluate the risks that they are taking due to a penalty clause. Accordingly, a legal form of paternalism may be warranted.

Another group of arguments focuses on judges’ decisions and leads to opposite conclusions. Specifically, courts suffer from biases, as do all humans, including (1) hindsight bias, (2) fair biases, and (3) framing effects. For this reason, they are not able to conduct those evaluations that a penalty doctrine asks of them; mistakes are the rule while correct evaluations are the exception. The most efficient solution is to drop the penalty doctrine and the strong paternalism that inspires it and apply general doctrines like unconscionability or duress to all liquidated damages provisions.

This Article aims to find a third solution: the generalization that is at the basis of the penalty doctrine appears too broad. In other words, the same overoptimism that leads a naive consumer to a wrong choice would lead a group of managers with different experiences, who make a collective decision, to the same mistake. This seems to be a counterintuitive generalization. It is possible that some debiasing mechanisms exist, and, thanks to this, some decisions are not a product of overconfidence, overoptimism, or the illusion of control. Evidence in this regard is represented by the empirical results of, for example, excellent calibration of some classes of people.

VII. NEW BOUNDARIES: DEBIASING THROUGH HIERARCHIES

Cognitive psychology gives us a deeper knowledge of the human decision making processes. Supporters of this discipline point out that it differs from neoclassical rational decision theory in its ability to avoid

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60 See supra notes 34–47 and accompanying text.
61 See supra Part IV (providing a detailed explanation of the three types of biases).
62 See generally Hillman, supra note 7.
63 See, e.g., Burton P. Fabricand, Horse Sense: A Rigorous Application of Mathematical Methods to Successful Betting at the Track 34–35 (1965); see also Sarah Lichtenstein et al., Calibration of Probabilities: The State of the Art to 1980, in Judgment Under Uncertainty: Heuristics and Biases, supra note 46, at 321 (discussing the results of demonstrating superb calibration of weather forecasters’ precipitation predictions).
false generalizations. For this reason, the results that have been obtained with regard to penalty clauses (i.e., justifying the penalty doctrine on the assumption that people, generally speaking, are overconfident and overly optimistic) is unsatisfactory. Indeed, it is another generalization, with the difference being that its content is opposed to what could be drawn from neoclassical rational choice theory.

As mentioned above, in Germany two different schools of thought are in force with respect to penalty clauses, one found in the Civil Code and the other in the Commercial Code. The Civil Code states that judges can reduce the penalty if it is disproportionately high. No such discretion is found in the rules in the Commercial Code: there are no limits to the freedom of contract.

It is interesting to highlight, as far as U.S. common law is concerned, a particular discipline that is somewhat understudied. This is the discipline known as “disproportionality doctrine.” Consider the Restatement (Second) of Contracts § 351(3), which states that “[a] court may limit damages for foreseeable loss by excluding recovery for loss of profits, by allowing recovery only for loss incurred in reliance, or otherwise if it concludes that in the circumstances justice so requires in order to avoid disproportionate compensation.” Comment f of this section states, “The limitations dealt with in this Section are more likely to be imposed in connection with contracts that do not arise in a commercial setting.”

Note, there is a distinction between rules destined to be applied to commercial players and rules intended for non-commercial players (consumers). The question arises as to whether there are debiasing mechanisms capable of supporting such a distinction. Individual choices about liquidated damage provisions can be the product of a debiased choice so that the common law penalty doctrine seems just as unjustified as civil law doctrines. Thus, the focus will be on business organizations.

Is it then possible to identify some debiasing procedures within the hierarchy, and, more generally, the mechanisms that allow an

64 J. Frank McKenna, Liquidated Damages and Penalty Clauses: A Civil Law Versus Common Law Comparison, LEXOLOGY (May 12, 2008), http://www.lexology.com/library/detail.aspx?g=d413e9e1-6489-439e-82b9-246779648efb (“There is a distinction between liquidated damages (Schadenspauschale) and contractual penalties (Vertragsstrafe) in the German Civil Code, and both are allowed according to article 340 and 341 of the BGB. The difference between them is that the latter can be mitigated if ‘disproportionate or excessively high.’”) (citation omitted).

65 See generally Garvin, supra note 25, at 345–60 (providing the origins of disproportionality and defining its current formation as of 1998).


67 Id. at § 351(3) cmt. f.
organization to work? That is not to say that the results about experience must be considered conclusive. It is possible that new studies could demonstrate the ability of experience to weaken some biases, such as overoptimism and overconfidence. But it is quite possible that other factors can have the same, if not stronger, influence in leading individuals to make more rational decisions.

In a typical business organization, relations among staff have a hierarchical form. This means that usually a decision taken by a subordinate is evaluated by a senior colleague. There is one important phenomenon produced by a hierarchical relationship: the pressure of accountability.68 Decision makers become more risk-averse when they expect their choice to be reviewed by others, and they prefer to avoid any kind of choice that implies even a small increase in the probability of a disaster.69 Risk aversion is a consequence of loss aversion, and it is not mitigated when decisions are made in an organizational context. As Kahneman and Lovallo point out, “On the contrary, the asymmetry between credit and blame may enhance the asymmetry between gains and losses in the decision maker’s utilities.”70 As for managers, it has been noted in a survey that they appeared to have an excessive aversion to loss outcome that could in fact yield a net loss.71 Aside from this particular managerial tendency, which is contrasted by other behavioral aspects, it is important to highlight the existence of mechanisms of accountability for management choices. As for corporations, executives are subject to the control of boards of directors, which usually includes non-executive directors.

“Pressure of accountability” not only has an impact in terms of increasing risk aversion, but also in the form of a debiasing effect.72 When an individual is accountable for his decisions, firstly, he cannot

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68 See Jennifer S. Lerner & Philip E. Tetlock, Accounting for the Effects of Accountability, 125 PSYCHOL. BULL. 255, 259–63 (1999) (providing a complete review of research literature on the effects of accountability on cognitive biases).


70 Kahneman & Lovallo, supra note 55, at 22.


72 Kahneman & Lovallo, supra note 55, at 22 (“The evidence indicates that the pressures of accountability and personal responsibility increase the status quo bias and other manifestations of loss aversion.”). Notwithstanding these opinions, the two authors conclude that decisions in a firm are generally over-optimistic. For example, they state that “[j]essimism about what the organization can do is readily interpreted as disloyalty, and consistent bearers of bad news tend to be shunned.” Id. at 28. However, because subordinates must always answer to superiors, it is possible that a stronger sense of realism is necessary.
follow his “intuitive judgment” 73—what Kahneman and Lovallo refer to as the “inside view of the problem.” 74 The intuitive judgment cannot be overviewed by other staff members, and, for that reason, it cannot be a way of justifying a decision in a hierarchical organization. When intuitive judgment is abandoned, an effort must be made to single out all the consequences of a decision, evaluating remote risks without removing them from the scenario. This phenomenon may be called “personal responsibility.”

Accountability also tends to force an “outside view of the problem,” because a justification of a choice based on statistical data is a more objective way to defend the worker’s own decision, especially when the manager does not have inside information about the decision. 75 When people follow an inside view of the problem, “[t]hey . . . forecast[] by focusing tightly on the case at hand—considering its objective, the resources they brought to it, and the obstacles to its completion; constructing in their mind scenarios of their coming progress; and extrapolating current trends into the future.” 76

Instead, “[the outside view] involved no attempt at forecasting the events that would influence the project’s future course. Instead, it examined the experience of a class of similar cases, laid out a rough distribution of outcomes for this reference class, and then positioned the current project in that distribution.” 77 The outside view of the problem “focuses on the statistics of a class of cases chosen to be similar in relevant respects to the present one.” 78

It is recognized that the inside view of the problem generates overly optimistic opinions, so pressure of accountability not only counterbalances some biases because it is at the root of risk aversion, but it also tends to lead to debiasing decisions. 79 Accountability also has an

73 See generally HEURISTIC AND BIASES: THE PSYCHOLOGY OF INTUITIVE JUDGMENT (Thomas Gilovich, Dale Griffin & Daniel Kahneman eds, 2002) (explaining generally the psychology of “intuitive judgment” and the remarkable amount of biases that distort it).
74 Regarding forecasts expressed on the base of the inside view of the problem in a concrete case, Kahneman and Lovallo state, “Not surprisingly, the resulting forecasts, even the most conservatives ones, were exceedingly optimistic.” Lovallo & Kahneman, supra note 33, at 61.
75 See supra note 41.
76 Lovallo & Kahneman, supra note 33, at 61.
77 Id. Since liquidated damages provisions present some peculiarity, Kahneman and Lovallo’s remarks are convincing. Kahneman & Lovallo, supra note 55, at 30. “A deliberate effort will therefore be required to foster the optimal use of outside and inside views in forecasting, and the maintenance of globally consistent risk attitudes in distributed decision system.” Id.
78 Kahneman & Lovallo, supra note 55, at 25.
79 Id. at 25–27; Lovallo & Kahneman, supra note 33, at 61.
effect on overconfidence; some studies give the results of a decreased overconfidence and an improved calibration. There is evidence of a bias attenuation.80 This is also true for executives when they are accountable to a board of directors. The presence of non-executive directors, sometimes independent members who are not involved in all the steps of a decision, gives rise to the outside view of the problem, which is less biased and more accurate.81

VIII. WHAT SHOULD BE DONE WHEN DEBIASING MECHANISMS ARE NOT PRESENT?

When a business organization takes the form of a corporation, it is also possible to identify some debiasing mechanisms with regard to managers’ decisions. It might be possible to adopt a separate discipline for penalty clauses signed by agents of a corporation, because there should be a presumption in favor of rational choices and a decision based on an illusion of hope. In this case, it should be stated that the main factor in debiasing decisions taken by company agents is not experience, but primarily mechanisms that are characteristic of a hierarchical organization and, as far as debiasing mechanisms regarding managers’ choices, peculiar to corporations.

Not all of these conclusions are valid for individual entrepreneurs who own a small firm. This is a hypothesis that presents some problems because the decision maker (i.e., the entrepreneur) does not make decisions through processes similar to those that have been identified in a hierarchical organization. In this case, decisions can be biased by overoptimism and overconfidence.82 The inside view of the problem and the intuitive judgment are destined to prevail over “statistical evaluation” (the outside view of the problem) and a more complete identification of risks.83 The illusion of hope can be present even if the


81 There is a further reason which may drive managers to be risk averse—hindsight bias of the board of directors. In the event of a choice with a low probability of a negative outcome actually resulting in that very same negative outcome, hindsight bias drives the members of the board to believe that management had underestimated the probability of an undesired result. This then gives rise to a tendency toward more conservative choices.

82 See supra notes 34–47 and accompanying text (discussing the overoptimism and overconfidence biases).

83 See generally HEURISTIC AND BIASES: THE PSYCHOLOGY OF INTUITIVE JUDGMENT, supra note 73. In this book, “intuitive judgment” is characterized by the presence of euristics and biases that can emerge if debiasing processes do not operate.
entrepreneur is a sophisticated businessperson. In this way, a distinction made by ruling judges can be developed in a manner that does not precisely correspond between commercial and non-commercial players, but rather seeks to recognize differences within the category of commercial players.

A commercial player, for example a single entrepreneur, can suffer from overoptimism, overconfidence, and the illusion of control. If a firm is controlled by a single person and does not have a strong hierarchical organization, it can have the same problems that a consumer encounters. On the other hand, a commercial player—in which precise hierarchies and a board of directors are present—may have some established mechanisms to debias choices. The former case would nevertheless be judged as if the relevant party were a consumer, since her experience has no legal validity.

As for consumers, it seems apparent that it is quite difficult to imagine situations in which debiasing mechanisms, such as those singled out above, can operate. On the basis of our analysis, consumers can be overly optimistic, overconfident, and can have the illusion of control, and these biases are destined to distort their choices because consumers usually do not bear the pressure of accountability. In the case of consumers, experience is also less of an influencing factor. Cognitive psychology, however, may produce new results concerning this in the future.

IX. SOME PRESCRIPTIVE SUGGESTIONS

As argued above, cognitive psychology is a tool with which it is possible to avoid substituting the broad neoclassical generalization (all individuals are competent) with another generic classification (all people are overly optimistic, overconfident, and have an illusion of control). In the hypothesis (e.g., in a business organization), it has been possible to

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[T]he early studies of euristics and biases displayed little interest in the conditions under which intuitive reasoning is pre-empted or overridden—controlled reasoning leading to correct answers was seen as a default case that needed no explaining. A lack of concern for boundary conditions is typical of young research programs, which naturally focus on demonstrating new and unexpected effects, not on making them disappear.


See generally Einhorn & Hogarth, *supra* note 55.

See *supra* Part IV (discussing over-optimism, over-confidence, and the illusion of control).
single out mechanisms that have the quality of debiasing choices, at least partially, and so it is conceivable that the law could equally determine whether decisions are made by rational decision makers.

In the previous analysis, it has been shown that in moving from the organization of a corporation to that of a small firm owned by a single entrepreneur, debiasing mechanisms tend to diminish or even disappear. The hope, however, is that in the future cognitive psychology will be able to help legal scholars identify more precisely all situations where a decision is taken through a debiasing process and conversely the cases where it is not.

The proposal, from a normative perspective, is twofold. The first one regards the *Italian Civil Code*. According to section 1384, “The penalty may be reduced if . . . its amount is manifestly too high . . . .” Courts and scholars hold that in order to evaluate whether the penalty is manifestly too high, it is necessary and sufficient to consider the amount of the penalty. Following this line of reasoning, the penalty could also be reduced when the clause is inserted in a contract between two large corporations. The proposal is that it may be possible to evaluate whether a penalty is manifestly too high by scrutinizing not only the amount of the stipulated damages, but also the bargaining process. In other words, a penalty clause could be declared manifestly high if there is some form of ‘bargaining naughtiness.’ The adverb “manifestly” should also involve some procedural control to verify that decisions taken by the parties were subjected to some debiasing processes.

The second part of the proposal regards U.S. penalty doctrine. As previously discussed, some scholars propose applying the unconscionability doctrine to all liquidated damages clauses. This clause presents some peculiarities, and the possibility of biased decisions is higher than in many other cases. Consider that the first requirement of the penalty doctrine, which renders a clause “void” (“[t]he amount fixed in the provision is not a reasonable estimate of the actual loss”), constitutes precisely the condition for “substantive unconscionability.” In this case, substantive unconscionability is predetermined. The second requirement (“[a]ctual damages are not difficult to estimate”) should be dropped because it “is irrelevant [in] determining whether a liquidated

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88 Eisenberg, supra note 9, at 235.
89 *Id.* at 225.
90 *Id.*
damages provision is a product of the limits of cognition.” 91 However, this form of unconscionability should not be sufficient. “Procedural unconscionability” should also be necessary. Additionally, in order to identify procedural unconscionability’s hypotheses, the tools of cognitive psychology, which we have attempted to apply in the case of (hierarchical) business organizations, seem necessary and valid since they are supported by established scientific findings and are destined to give more useful tools through advances in this field of research.

X. THE DISCIPLINE IN ITALY AND THE UNITED STATES

A comparable discipline of cases, which recall that dictated by the doctrine of unconscionability, can be found in Italian law. In fact, there are a number of scenarios in which the legal system demands not one, but both types of unconscionability.92

The two cases that follow are typical examples from the area of contract voidability (cancellation). Codice Civile article 1447 concerns voidability of contracts drafted under threat of danger and states that whosoever draws up a contract taking on oppressive obligations for the purposes, known by the counterparty, of saving himself or others in grave personal danger may be liable to contract cancellation at the request of the obligated party.93 As can be seen, this constitutes a case of bargaining naughtiness, i.e., the condition of grave personal danger together with a substantive naughtiness, and the oppressiveness of the obligation. One condition without the other would not be sufficient.94

The second case, contract voidability due to damages (Codice Civile article 1448), relates to a party who has drafted a contract out of necessity and is then taken advantage of by the counterparty such that damages are incurred equal to half the value of the goods.95 This example also includes a case of procedural unconscionability alongside substantive unconscionability.96

91 Id. at 235.
92 Id. at 234. Eisenberg prefers not to speak of unconscionability with regard to penalty clauses, probably because the doctrine of unconscionability covers the case of quasi-duress and quasi-fraud, while these cases concern mistakes. Id. It is worth stating that this doctrine also covers cases of unfair surprise. Id. See generally Arthur Allen Leff, Unconscionability and the Code – The Emperor’s New Clause, 115 U. PA. L. REV. 485 (1966) (discussing quasi-duress and quasi-fraud).
94 Id. at art. 1448.
95 Id.
96 Eisenberg prefers not to speak of unconscionability with reference to penalty clauses, probably because the doctrine of unconscionability covers the case of quasi-duress and...
However, the discussion may be broadened by considering the context of contracts in which one party is a consumer. Many of these contracts are governed by a discipline that is somewhat different from the traditional approach. Again, this can be described as a case of procedural unconscionability (the fact that one party is a consumer). The presence of a consumer as a party compromises the perfect functionality of the exchange as an expression of absolute and informed freedom.

Admittedly, there are also scenarios in the Italian system according to which substantive unconscionability itself renders the contract or the relevant clause invalid. This is the case, for example, in article 1229, which stipulates that any agreement that excludes a party from fraud or other grave culpability, or limits such culpability, is legally null and void.97 In this case, substantive unconscionability is a symptom of procedural unconscionability.

As Craswell outlines with regard to American law, “[S]ome courts have suggested a vaguely mathematical metaphor in which a large amount of one type of unconscionability can make up for only a small amount of the other.”98

The idea of a kind of mathematical formula, in which the greater part is substantive unconscionability and correspondingly the minor part is procedural unconscionability, may be applied to both the Italian and American legal systems. This is possible if we assume that forms of substantive unconscionability are symptoms of underlying cases of procedural unconscionability and, conversely, that strong forms of procedural unconscionability are deservedly considered invalid to produce valid incentives for a party to obtain proper consent from its counterparty.99 It is also possible that strong forms of procedural unconscionability are themselves symptoms of an underlying substantive unconscionability.

The formula is thus expressed in the case of *Tacome Boatbuilding Co., Inc. v. Delta Fishing Company, Inc.* by Judge James Burns. “Of course, the substantive/procedural analysis is more of a sliding scale than a true quasi-fraud, while these cases concern mistakes. It is worth stating that this doctrine also covers cases of unfair surprise. See Eisenberg, *supra* note 9, at 234; Leff, *supra* note 92.

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99 Craswell, *supra* note 16, at 6 & fig. 1 (providing a decision tree with regard to determining proper consent).
dichotomy. The harsher the clause, the less 'bargaining naughtiness' that is required to establish unconscionability."\textsuperscript{100}

This is however not the case for penalty clauses. These are invalid in the American system and may be reduced in the traditional continental systems if there is substantive unconscionability without the balancing formula proposed above. Consideration must be given to the tendency to evaluate the fairness of a penalty clause ex post (i.e., by referring to the effective damages suffered compared with that foreseen in the penalty clause). In such a case, even a correct evaluation of the expected damages ex ante would be repudiated, and the judge would enforce his or her own decision rather than that liberally taken by the party in question.\textsuperscript{101}

As far as U.S. common law, the solution could be to apply the doctrine of unconscionability with some peculiarity. As we have seen, substantive unconscionability should be determined ex ante, while procedural unconscionabilibility should be affirmed in any case in which a debiasing mechanism is not individuated.

This Article has sought to propose solutions for removing this doctrine which is so firmly rooted in American law. An attempt has been made to demonstrate that mechanisms exist for debiasing decisions that should exclude procedural unconscionability and consequently render unjustified the voidness of the clause. An explanation has been given of the background that has led some courts to use a type of mathematical formula in which strong substantive unconscionability requires, for the invalidity of the clause, a more moderate procedural unconscionability. Conversely, a strong procedural unconscionability, again of the clause being invalidated, requires less robust substantive unconscionability.

The mathematical formula is a new and interesting solution for these kind of problems. A strong finding of procedural unconscionability could require, in many cases, no substantive unconscionability, and


\textsuperscript{101} Melvin A. Eisenberg favors an ex post evaluation of the reasonableness of penalty clauses, asserting, “A second-look standard for liquidated damages provisions is justified not because a second look may show that a provision was unconscionable, but because it may show that the provision was in all likelihood the product of defective cognition.” Eisenberg, \textit{supra} note 9, at 234. However, it is difficult to imagine that in every case where the predicted ex ante damages differ from the actual loss, this is due to defective cognition. In predicting the damages ex ante, the parties formulate an idea of plausible future damages and it is then possible that the true outcome is less fortunate, albeit improbable, for the party in question.
strong substantive unconscionability is typically a symptom of procedural unconscionability.

XI. CONCLUSIONS AND AREAS FOR FUTURE RESEARCH

This Article has made use of cognitive psychology for an objective directly opposed to the normal purpose of this branch of behavioral science. In fact, cognitive psychology offers arguments for those scholars seeking to introduce moderate forms of paternalism; in some cases, it serves as a tool and is therefore espoused by some authors who hold views ideologically opposed to the concept of full contractual freedom of the individual.102

However, in studying penalty clauses, I have used cognitive psychology in an attempt to broaden contractual autonomy. Therefore, faced with a doctrine that consistently declares a certain clause invalid (or, in the case of continental legal systems, reduces the penalty), cognitive psychology may be used to identify hypotheses regarding the robustness of the clause. This Article has sought to draw on cognitive psychological tools to identify cases in which placing such limitations on contractual freedom does not appear justified. The result of this analysis contrasts strongly with both the attitude of American courts and the tendencies of Western legislative bodies. The distinction that has come to light is not between commercial parties and consumers, nor between professionals and consumers, but instead is generally between sophisticated and non-sophisticated parties, or repeated and non-repeated players. Such distinctions, however, do not appear particularly useful for pinpointing hypotheses in which penalty clauses can be considered valid independently from their content. To this end, a distinction has been introduced between parties with a hierarchical organization and those not organized in this fashion. Therefore, particular attention has been given to the pressure of accountability and the outside view of the problem, two phenomena which, in my opinion, are able to provide a more thorough evaluation of the costs and benefits of contracts containing contractual clauses.

Pressure of accountability favors judgments not affected by overoptimism, overconfidence, and the illusion of control, since whoever puts them forward may be called to answer for his or her decisions or may be subject to remedial penalties. This means that all aspects of a decision must be carefully evaluated, and the party must have a clear picture of the factors that could be called into question.

102 See Rachlinski, supra note 54, at 1177–82 (discussing freedom of contract).
The outside view of the problem, although still a generic concept, suggests the idea of an assessment carried out by using information from previous cases to determine the likelihood of outcomes in the case in question. This enables overconfidence and overoptimism, along with individuals’ illusion of control, to be kept in check.

It remains to be established when these phenomena operate. In fact, it is not easy to determine whether a party has made a decision from an assessment based on the outside view of the problem or by adapting to the inside view of the problem of his/her superior. Perhaps it is necessary to carry out evaluations on a case-by-case basis, even though this gives rise to grave uncertainty. However, there is an equally grave uncertainty in the continental systems that allow a judge to reduce penalties to a level considered equitable. The same is true for personal responsibility, because the subordinate could adapt his/her judgment to the inside view of the senior.

The intention of this Article has essentially been to move away from the system of approval used by large companies for contract clauses in which individuals prepare an agreement, managers assess the document, others approve it, and finally the members of the organization who will work with the contract take it on-board. This chain of command seems to me to be sufficient to generate debiasing mechanisms which are able to put single clauses beyond question.

As has been seen, the same cannot be said for smaller individual entrepreneurs who make business decisions on their own behalf. In this case, the above debiasing mechanisms are not in operation and clauses must be evaluated on their own merits.

It is evident that in this Article the distinctions between commercial and non-commercial players and sophisticated and non-sophisticated parties have been abandoned. Rather, the key aspects concern the process of the formation of a willingness to enter into a contract, analyzing the presence or otherwise of debiasing mechanisms.

As stated previously, this analysis is not considered exhaustive. Other debiasing mechanisms may exist, for example, for consumers, which have not been at all studied. Neither have the debiasing effects been considered for certain external agents of companies, such as lawyers and consultants. Instead, the starting point has been the observation from experimental economics, which states that only certain conditions that typically exist solely in the laboratory are able to correct the effects of individuals’ overoptimism and overconfidence. The experience of the parties is not such a powerful debiasing tool.

This result conflicts with the commonly held view that the parties with the most experience require the least protection; conversely, the
view that parties with less experience require greater protection can be countered by considering that if debiasing mechanisms are in operation, the unquestionable nature of decisions can be supported.

As far as areas of future research, this work is incomplete. It remains to be understood, for example, how many levels of hierarchy are necessary in order to debias a decision, and, to give another example, when it is possible to affirm that an outside view of the problem is properly followed.

There are many other interesting areas to investigate. It is possible to find mechanisms of debiasing in other situations, for instance, when one party is a consumer. Also, a low probability, high magnitude risk would not create as many problems if it were highly salient and the party were to face it frequently. Law and cognitive psychology give us the ability to reinterpret contract law in a way to obtain successes and not only failures.103

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