Liquidated Damages in Montana

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LIQUIDATED DAMAGES IN MONTANA

Daniel Browder*

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I. INTRODUCTION

The law of liquidated damages in Montana is a maze in which every junction leads to a blind alley. Only one case considering the enforceability of liquidated damages clauses truly remains "good law" in Montana; the others have been overruled, withdrawn, or rendered irrelevant. The one good case, however, may also lead to a blind alley.

This Comment examines the Montana Supreme Court's three very different interpretations of liquidated damages in three lines of cases. The first line of cases consists of a century of essentially overruled case law generally interpreting a state statute according to its plain meaning. The second line, still officially valid precedent, rests on a 2003 case that expressly rejected the plain meaning of the statute, impliedly rejected the statute itself, overruled much of the previous century's case law, and presented an entirely new test for enforceability of liquidated damages clauses. The third line consists of a 2005 case — withdrawn for reasons unrelated to liquidated damages — that ignored the court's new-in-the-box 2003 test, and resurrected the statute through an anal-

1. A "liquidated damages" clause is included in a contract to stipulate, in advance, how much a breaching party must pay a non-breaching party. Many types of contracts contain liquidated damages clauses: a real estate buy-sell agreement may require a down payment to be paid as damages if the buyer does not close the deal; a contract for the sale of goods may stipulate what damages the seller must pay if the seller's breach damages the buyer. See infra Section II.B. This Comment mainly discusses liquidated damages in contracts not covered by the Uniform Commercial Code, i.e., contracts not for the sale of goods. Liquidated damages in goods contracts are governed by MONT. CODE ANN. § 30-2-718 (2005).


[O]ur precedent has both required and completely ignored proof that damages be of a type difficult to ascertain; it has relied on proof of actual damages to show reasonableness and it has rejected proof of actual damages to show reasonableness; it has considered actual bargaining as only one factor to be considered and it has held actual bargaining is required; finally, it has considered the penalty/liquidated damages issue as one that requires evidence and also one that is based on contract interpretation.


ysis premised on a legal error. These unsatisfactory choices embody the unsettled law of liquidated damages in Montana and illustrate how Montana’s statute-based contract law distorts basic principles of contract law.

Two colliding tectonic principles of law created the thrust fault that is the law governing liquidated damages: the principle of freedom of contract, and the principle that penalties will not be enforced. Freedom of contract, bedrock of the private law of contracts, holds that a clause fixing damages should be enforced simply because the parties agreed to it. The prohibition of penalties holds that a liquidated damages clause must be scrutinized carefully, regardless of the parties’ agreement, because damages must be used only to compensate, never used in terrorem to compel the other party’s full performance under the contract. These two principles have piled up against each other for centuries; the collision has created a notoriously inconsistent area of law.

Over the last century, the prohibition-of-penalties plate has ebbed. The doctrine of unconscionability has gradually expanded to cover areas traditionally protected by the ban on penalties, and modern merchants rely increasingly on liquidated damages clauses to reduce the likelihood and costs of litigation. Modern courts are thus more likely than their predecessors to favor freedom of contract by enforcing parties’ stipulated damages clauses.


6. 3 E. ALLEN FARNSWORTH, CONTRACTS § 12.18, at 301 (3d ed. 2004).


8. See, e.g., Jaquith v. Hudson, 5 Mich. 123 (1858) ("[J]udges have been long and constantly complaining of the confusion and want of harmony in the decisions upon this subject.").

9. 3 FARNSWORTH, supra note 6, § 12.18, at 303.


11. See, e.g., Priebe & Sons, Inc. v. United States, 332 U.S. 407, 411 (1947) ("Today the law does not look with disfavor upon 'liquidated damages' provisions in contracts."); Walter Motor Truck Co. v. State, 292 N.W.2d 321 (S.D. 1980); 3 FARNSWORTH, supra note 6, § 12.18, at 303-04 (noting that liquidated damages clauses are increasingly enforced by courts).
Under the rule in effect in most jurisdictions from the early-to mid nineteenth century until around the first part of the twentieth century, a liquidated damages clause was enforceable if (1) the amount was a reasonable forecast of actual damages and (2) the damages caused by the breach were very difficult to estimate at the time the contract was formed.\textsuperscript{12} This Comment refers to these two elements as the reasonableness element and the difficult-to-estimate element. During this period, most jurisdictions probably considered the reasonableness element primary. Under the modern rule, a court looks only to the reasonableness element to determine enforceability. The difficult-to-estimate element is no longer a separate prong of the rule.\textsuperscript{13}

In Montana, liquidated damages — like much of contract law — are governed not by the common law, but by statute.\textsuperscript{14} Montana statutory contract law owes its existence to the Field Civil Code, the 1865 volume of model statutes governing civil law.\textsuperscript{15} The state of New York commissioned the effort to codify the entire body of civil common law; the commissioners were led by the indefatigable David Dudley Field.\textsuperscript{16}

Montana’s statute governing liquidated damages was taken practically verbatim from the Field Civil Code. Field’s statute was intended to mimic the common law rule of the 1860s when he wrote the Civil Code. But the statute mimicked only half of the common law rule of its time — the difficult-to-estimate half.\textsuperscript{17} Thus in Montana, the less important element was crystallized in statute as the law of liquidated damages even as the common law marginalized that element. The result has been increasing tension between Montana’s rule for liquidated damages on one side,

\textsuperscript{12} Banta v. Stamford Motor Co., 92 A. 665, 667 (Conn. 1914); Restatement of Contracts § 339 (1932). See infra Section III.A. (discussing the history of the common law rule).

\textsuperscript{13} Restatement (Second) of Contracts § 356 (1981). See infra Section III.A. for discussion of the prevailing common law rules.


\textsuperscript{16} Field Civil Code (1865). Though technically authored by several commissioners, Field is widely regarded as the Code’s author. This Comment follows that convention and refers to the document as Field’s creation.

\textsuperscript{17} Mont. Code Ann. § 28-2-721 (2005).
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and generally accepted commercial practice and the prevailing legal rule on the other.

Perhaps partly because of this tension, the Montana Supreme Court in two recent cases enforced disputed liquidated damages clauses without applying the plain meaning of the controlling statute. In a 2003 case, Arrowhead School District No. 75 v. Klyap, the court overruled or rendered irrelevant practically all previous liquidated damages case law, and enunciated an entirely new test to determine the enforceability of liquidated damages clauses, effectively supplanting the statute. The Klyap majority held that henceforth liquidated damages clauses will be presumed enforceable; only unconscionable clauses will be unenforceable.

Two years later, Cole v. Valley Ice Garden, L.L.C. (Cole I) presented the Montana Supreme Court its next opportunity to consider the enforceability of a liquidated damages clause. In its discussion of the statute, the court failed to mention that Klyap had effectively nullified the statute. Instead of applying the Klyap unconscionability test, the Cole I majority held that the parties waived the liquidated damages statute. The Cole I court's waiver analysis utilized one of the highly generalized statutory "maxims of jurisprudence," but was based on the faulty premise that the law of liquidated damages is a default rule (one that parties may contract around), rather than a mandatory rule (one that parties may not contract around). The court's confusion over mandatory versus default rules makes the waiver maxim particularly dangerous.

On rehearing the case, the court withdrew Cole I and, because the earlier opinion applied the wrong standard of review to the trial judge's findings, issued a superseding opinion (Cole II). Because Cole II bypassed liquidated damages entirely, questions raised by the court's Cole I analysis remain afloat, even after the first opinion was scuttled.

19. Id.
20. Id. ¶¶ 48, 50. See Burnham, Let's Repeal the Field Code!, supra note 5, at 45-46 (discussing liquidated damages and Klyap).
22. Id. ¶ 37.
Montana's liquidated damages statute is a faulty enunciation of a common law rule that is itself now obsolete. This Comment argues that the Montana Supreme Court's treatment of liquidated damages illustrates the unsettled nature of Montana's liquidated damages law, the negative influence of the Field Civil Code on Montana's contracts jurisprudence, and the dangers of confusing default and mandatory rules.

Section II of this Comment discusses the Field Civil Code and the history and underlying principles of the law of liquidated damages. Section III considers the rules governing liquidated damages under the common law and under Montana's statutory regime. Section IV discusses Klyap and the unconscionability test. Section V discusses Cole I, its waiver analysis, and Cole II, the superseding opinion. Section VI discusses the lessons to be learned from the case law. Section VII concludes.

II. BACKGROUND

A. The Field Civil Code

The Field Civil Code became part of Montana law courtesy of renowned New York City attorney David Dudley Field. Field led the determined and vociferous nineteenth century movement of philosophers, lawyers, judges, and business interests to displace the common law with legal codes.25 Advocates won an early victory in New York, where the legislature enlisted a commission headed by Field to codify all aspects of the common law.26

Field compiled his six model code volumes — Code of Civil Procedure, Book of Forms, Code of Criminal Procedure, Political Code, Penal Code, and Civil Code — over the course of almost twenty years.27 The New York Legislature enacted the Code of Civil Procedure in 1848, but as the later codes were reported to the Legislature — the last in 1865 —, codification's momentum in


27. FIELD CIVIL CODE xii (1865); Andrew P. Morriss, "This State Will Soon Have Plenty of Laws" — Lessons from One Hundred Years of Codification in Montana, 56 Mont. L. Rev. 359, 367-68 (1995) [hereinafter Morriss, "This State Will Soon Have Plenty of Laws"].
New York had slowed.28 The Civil Code, Field's most revolutionary and ambitious code, intended to supplant the civil common law entirely, was never enacted in New York.29 The ground proved more fertile in the American West, where Territorial law, changing jurisdictions, and foreign influences created a legislative and legal hodgepodge.30 First the Dakota Territorial Legislature enacted the Civil Code in 1866.31 Then in 1872, the California Legislature enacted slightly modified versions of four of Field's codes: Civil Procedure, Penal, Political, and, most importantly for this discussion, the 1865 Civil Code.32 The Montana Legislature enacted the California version of the four codes practically verbatim in 1895.33

Although much of the other three codes enacted in Montana have been repealed or superseded, many Civil Code sections remain unchanged.34 When enacted, the code sections formed a logically ordered block, but now they are littered throughout the articles of the Montana Code Annotated.35 One hundred fifty-two of the remaining Montana Field Civil Code statutes address the law of contracts.36

B. Liquidated Damages: Principles and History

The law governing contract payments or obligations before breach differs qualitatively from the law governing payments or obligations after breach. While contract law grants parties great latitude to negotiate substantive duties or payments under a contract, in keeping with its primary role to facilitate exchange relationships and commerce,37 the law severely restricts parties'

28. Field had better luck in New York in the 1880s: The Penal Code was enacted in 1881, and parts of the Political Code were enacted throughout the 1880s. Morriss, "This State Will Soon Have Plenty of Laws," supra note 27, at 367-68.
29. Id. at 369-70.
32. Id. at 362-63.
33. Id.; Morriss, Codification and Right Answers, supra note 25, at 367.
34. See, e.g., MONT. R. CIV. P. (replacing Field's CODE OF CIVIL PROCEDURE in Montana); Burnham, Let's Repeal the Field Code!, supra note 5, at 32-33, 35.
35. Burnham, Let's Repeal the Field Code!, supra note 5, at 32 ("[S]ome 766 Field Code provisions are scattered throughout the Montana Code Annotated . . . .").
36. Id. at 35.
37. 3 FARNSWORTH, supra note 6, § 12.18, at 300 n.1 ("Absent legislation, parties' power over substantive rights and duties is subject only to the restraints imposed by public policy and unconscionability.") (internal cross references omitted); Burnham, War Against Arbitration, supra note 14, at 139.
choice of remedies.\textsuperscript{38} The adages of consideration indicate the primacy of freedom of contract before breach: "the law will not enter into an inquiry as to the adequacy of the consideration";\textsuperscript{39} "[a] rose, a hawk, or a peppercorn will suffice provided it is what is asked for by the promisor."\textsuperscript{40}

While contract law tends not to poke its nose into the quantity of the contract's consideration, the law meddles a great deal in parties' choice of remedies. This meddling into stipulated remedies limits parties' freedom of contract and constitutes the law of liquidated damages.

Liquidated damages clauses save time and money if a contract is breached. The non-breaching party avoids the nearly inevitable expense, time, and difficulty of proving the amount of damages in court to a reasonable certainty.\textsuperscript{41} If the contract contains an enforceable liquidated damages clause, the non-breaching party will probably be granted summary judgment on the question of damages.\textsuperscript{42} The non-breaching party must prove only breach and causation, often a simpler matter. A liquidated damages clause will also allow a non-breaching party to receive compensation for damages that a court would be unlikely to recognize or value accurately, such as the value of lost opportunities.\textsuperscript{43}

The breaching party may benefit by a liquidated damages clause as well. Knowing the precise damages it will be required to pay, the breaching party can accurately calculate the costs and benefits of breaching the contract and allocate its resources to more productive pursuits. Both parties save time and legal fees as a result of the self-policing aspect of a liquidated damages clause.\textsuperscript{44}

The law of liquidated damages asks if stipulated damages are actually a penalty intended to coerce performance or punish breach. The origin of the principle prohibiting penalties lies not in the canon of contracts law, but in the courts of equity to protect

\textsuperscript{38} Charles T. McCormick, Handbook on the Law of Damages § 147, at 600-601 (1935) [hereinafter McCormick on Damages].


\textsuperscript{40} 1 Samuel Williston & George J. Thompson, A Treatise on the Law of Contracts § 115 (rev. ed. 1936).

\textsuperscript{41} 11 Joseph Perillo, Corbin on Contracts § 58.1, at 395 (rev. ed. 2005) [hereinafter Corbin on Contracts].

\textsuperscript{42} Burnham, Let's Repeal the Field Code!, supra note 5, at 46.

\textsuperscript{43} Id.

\textsuperscript{44} 3 Farnsworth, supra note 6, § 12.18, at 301.
against fraud and against penal bonds. In addition, the prohibition of penalties protects overly optimistic parties from their confidence that they can surely perform a contract and avoid an obvious penalty.

Some legal historians consider the prohibition of penalties one of the earliest equitable interventions to the law, tracing its origins to the fifteenth century, if not before. About the prohibition of penalties in English law, Holdsworth wrote:

It was obviously against conscience that a person should recover a sum of money wholly in excess of any loss incurred. A person seeking to do so might in some circumstances come perilously near to committing a fraud, and in other circumstances might be unconscientiously seeking to take advantage of an accident. . . . But as yet the limits of and the principles upon which [equitable relief from penalties] is exercised are vague.

Generally a clause that is held by the court to be a penalty does not infect the entire contract; the penalty is simply excised from the contract. The prohibition of penalties occurs mainly in common law countries; courts in civil law countries such as France and Germany consider penalty clauses enforceable, just like any other bargained-for contract term, although a judge may possess more discretion to modify the stipulated damages term than to modify more substantive terms of the contract.

45. Goetz & Scott, supra note 7, at 554; McCormick on Damages, supra note 38, § 147, at 601 (explaining that unscrupulous use of penal bonds to compel contract performance was the impetus and foundation for the general prohibition of contract penalties).

46. McCormick on Damages, supra note 38, § 147, at 601 ("It is a characteristic of men, however, that they are likely to be beguiled by the 'illusions of hope,' and to feel so certain of their ability to carry out their engagements in future, that their confidence leads them to be willing to make extravagant promises and commitments as to what they are willing to suffer if they fail."); Jeremy A. Blumenthal, Law and Social Science in the Twenty-First Century, 12 S. Cal. Interdisc. L.J. 1, 29 (2002).

47. McCormick on Damages, supra note 38, § 147, at 601; William H. Loyd, Penalties and Forfeitures, 29 Harv. L. Rev. 117, 120-24 (1915). But see 3 Farnsworth, supra note 6, § 12.18, at 302 (claiming that the principle prohibiting penalties had become settled "by the latter part of the seventeenth century"); Robert E. Scott & George G. Triantis, Embedded Options and the Case Against Compensation in Contract Law, 104 Colum. L. Rev. 1428, 1440 (claiming that English courts adjudicating bonds sought to distinguish between penalties and liquidated damages from "the beginning of the eighteenth century").


49. 11 Corbin on Contracts, supra note 41, § 58.4, at 413.

50. Id.; 3 Farnsworth, supra note 6, § 12.18, at 302, 302 n.5; Ugo Mattei, The Comparative Law and Economics of Penalty Clauses in Contracts, 43 Am. J. Comp. L. 427 (1995).
Some scholars regard the prohibition of penalties as a relic of pre-industrial law that hinders efficient allocation of resources.\footnote{51} Law and economics scholars such as Judge Richard Posner and Professor Richard Epstein reject the assumptions underlying Anglo American law’s strict separation of damages and penalty.\footnote{52} Others claim that the prohibition of penalties promotes economic maximization.\footnote{53} Expectation damages — and thus also the prohibition of penalties — is often touted as an element of the doctrine of efficient breach,\footnote{54} which holds that a party should be free to breach a contract in pursuit of greater gains, provided that the breaching party compensates the non-breaching party for its losses (measured by the non-breaching party’s expectancies).\footnote{55} When the law promotes efficient breach, a party may reallocate its resources from a less profitable contracted use to a more profitable one, without penalty. Efficient breach thus enhances

\footnote{51. XCO Int’l, Inc. v. Pac. Scientific Co., 369 F.3d 998, 1002 (7th Cir. 2004); Goetz & Scott, \textit{supra} note 7, at 556, 556 n.12.

The explanation for the rule against penalty clauses may be purely historical—and “it is revolting to have no better reason for a rule of law than that so it was laid down in the time of Henry IV.” The slow pace at which the common law changes makes it inevitable that some common law rules will be vestigial, even fossilized.

\textit{XCO Int’l, Inc.}, 369 F.3d at 1002 (Posner, J.) (citation omitted) (quoting O. W. Holmes, Jr., \textit{The Path of the Law}, 10 \textit{Harv. L. Rev.} 457, 469 (1897)).

\footnote{52. See, e.g., Lake River Corp. v. Carborundum Co., 769 F.2d 1284, 1289 (7th Cir. 1985) (Posner, J.) (“[L]ike every other state, Illinois, untroubled by academic skepticism of the wisdom of refusing to enforce penalty clauses against sophisticated promisors continues steadfastly to insist on the distinction between penalties and liquidated damages.”) (citations omitted); \textit{XCO Int’l, Inc.}, 369 F.3d 998 (Posner, J.); Richard A. Epstein, \textit{Contracts Small and Contract Large: Contract Law Through the Lens of Laissez-Faire, in The Fall and Rise of Freedom of Contract} 25, 56-57 (F.H. Buckley ed., 1999); Ugo Mattei, \textit{supra} note 50, at 431; Scott & Triantis, \textit{supra} note 47, at 1432-33; 11 \textit{Corbin on Contracts}, \textit{supra} note 41, § 58.4, at 416 (“Some courts have doubted the soundness of the [liquidated damages] policy that sustained any such limitation [on freedom of contract] at all.”).


\footnote{54. See, e.g., Scott & Triantis, \textit{supra} note 47, at 1446.

\footnote{55. Justice Oliver Wendell Holmes, Jr. is considered an originator of the doctrine of efficient breach:

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

O. W. Holmes, Jr., \textit{The Common Law} 301 (1881) (quoted in Epstein, \textit{supra} note 52, at 55). Epstein described efficient breach as an “offshoot of the famous Holmes dictum.” Epstein, \textit{supra} note 52, at 56.}
economic efficiency and maximizes societal gain (or so the theory holds).\textsuperscript{56}

The law governing liquidated damages is a facet of the prohibition of penalties. If unenforceable liquidated damages are simply penalties, why is a separate doctrine necessary? Although perhaps redundant, separate enumeration of the doctrines of penalty and liquidated damages may have closed a loophole allowing penalties if the parties called them "liquidated damages." In a comment appended to the liquidated damages code section, Field wrote: "The use of the phrase 'liquidated damages' leads frequently to an evasion of the law in respect to penalties."\textsuperscript{57} An early nineteenth century New York case illustrates courts' focus on the parties' language to determine intent and enforceability: "It may be said that when the sum specified in the contract is described by the parties as liquidated damages [and the proportionate and certainty requirements are met], the language will be deemed expressive of the intent of the parties, and the specified sum will not be treated as a penalty."\textsuperscript{58}

\textsuperscript{56} Most, if not all, modern law and economics scholars criticize the economic justifications for efficient breach doctrine, and the doctrine itself:

The wheels of commerce work best when social pressures support the faithful performance of promises with a minimum of legal compulsion and interference. . . . The rule [of efficient breach] also allows promisors to be the arbiter of when they perform and when they pay, sharply contrary to the global expectations in standard commercial transactions. Theory aside, contract damages, as administered, often fail to bring the plaintiff to the position he would have enjoyed if the transaction were completed.

* * *

[Efficient breach] also allocates all the gains from breach to the party in breach . . . . [and] encourages individuals to profit from their own wrong.

\textsuperscript{57} FIELD CIVIL CODE § 83 cmt., at 255 (1865). Field added commentary to each Civil Code section, but these comments are generally not included in states' enacted versions of the Civil Code.


[W]henever the sum mentioned in any instrument must, from the express language of the instrument, . . . be considered as the ascertained or liquidated damages agreed to be paid by one party to the other on the . . . performance or omission of a particular act, the statute [prohibiting penalties] will not apply; for in such case the sum is not a penal sum; and Courts of Equity will not relieve against such sum, although they will against a penalty.

\textit{Id.} (emphasis added).
The "fuzzy line between penalty clauses and liquidated-damages clauses" has shifted in favor of freedom of contract since Field's day. Common law jurisdictions are much more likely to allow freedom of contract and enforce liquidated damages clauses, but the prohibition of penalties still lives. Like all restrictions on freedom of contract, the limitation on parties' ability to stipulate damages results from "notions of public policy." All rules that limit freedom of contract are mandatory rules, including the rules governing liquidated damages.

C. Default Rules and Mandatory Rules

The rules that make up contract law can be divided into two categories: default rules and mandatory rules. Default rules are inserted into a contract only when the parties fail to stipulate the relevant term; parties are free to contract around the rule. Mandatory rules, on the other hand, derive from public policy concerns and must be followed regardless of the parties' desire to deviate from them.

Default rules arise from a need to streamline commercial transactions, "both to reduce the costs of forming contracts in the first place and to eliminate uncertainty in contract disputes after the fact." A court applies a default rule in three steps: first, the court determines that the contract lacks a term that would settle the dispute; second, the court identifies the appropriate default rule from the law of contracts; and third, the court imputes the default rule to the disputed contract. As long as the parties include a particular term in their contract, they may waive a default rule. Most contract rules are default. For example, the rules

60. 11 CORBIN ON CONTRACTS, supra note 41, § 58.2, at 399.
61. Scott & Triantis, supra note 47, at 1444-45.
62. Stephen J. Ware, Default Rules from Mandatory Rules: Privatizing Law Through Arbitration, 83 MINN. L. REV. 703, 748 (1999); Burnham, War Against Arbitration, supra note 14, at 141. Professor Burnham describes the rules as being either "facilitatory" or "regulatory" rather than default or mandatory.
63. Ware, supra note 62, at 748.
64. Burnham argues that in an ideal contract law, statutes would govern mandatory rules and the common law would govern default rules. Burnham argues that Montana's corpus of Field Code statutory contract law confuses what is a mandatory and what is a default contract rule. Burnham, War Against Arbitration, supra note 14, at 144-47.
65. Epstein, supra note 52, at 28.
governing the timing of parties' performance under a contract are default rules.67

The ultimate overarching default rule is reasonableness. If no specific default rule exists to resolve an eventuality outside the parties’ contract, the Second Restatement section 204 describes the operation of the ultimate default rule: “When the parties to a bargain sufficiently defined to be a contract have not agreed with respect to a term which is essential to a determination of their rights and duties, [then] a term which is reasonable in the circumstances is supplied by the court.”68 Default contract rules are based upon what is reasonable; reasonable in turn is usually determined by common or commercial practice.69

Parties cannot contract around a mandatory rule. For example, parties may not stipulate that one party will not be bound by contract law's requirement of good faith and fair dealing.70 Another example of a mandatory rule is the statute of frauds, which requires certain agreements to be in writing.71 Parties cannot by-pass the rule by agreeing that their oral contract falling under the statute of frauds will be enforceable. The statute of frauds bars enforcement of certain contracts regardless of the parties’ intent.

Any contract rule (such as the those governing liquidated damages) that voids a contract term that fails a particular test must be mandatory. If the law renders a contract term void or unenforceable, then the parties are obviously not free to contract around the rule; the invalidated clause memorialized the parties’ unsuccessful attempt to contract around the rule.72

Mandatory rules restrict freedom of contract and come in two varieties. The first variety restricts parties from entering a particular kind of agreement at all. For example, contracts entered into for illegal objects are void as a matter of law, and many jurisdictions commonly forbade all commercial activities on Sundays.73

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67. See, e.g., Restatement (Second) of Contracts § 233 (1981) (“Where only a part of one party’s performance is due at one time . . . if the other party’s performance can be so apportioned that there is a comparable part that can also be rendered at that time, it is due at that time, unless the language or the circumstances indicate the contrary.”).
68. Restatement (Second) of Contracts § 204 (1981).
69. Burnham, War Against Arbitration, supra note 14, at 139.
70. Johnson, supra note 23, at 388.
72. Alan Schwartz & Robert E. Scott, Contract Theory and the Limits of Contract Law, 113 Yale L.J. 541, 609 (2003). (“Mandatory contract law rules ban terms that parties choose; hence, these rules are inconsistent with the commitment to party sovereignty.”).
73. 15 Grace McLane Giesel, Corbin on Contracts §§ 79.5, 82.1 (Joseph Perillo, ed. 2003) [hereinafter Giesel, Corbin on Contracts]. See also, Arthur Linton Corbin,
The second and most common variety of mandatory rule may allow parties to agree to a contract term but restricts its judicial enforcement. The statute of frauds illustrates this second type of mandatory rule. Parties may freely enter oral agreements for the sale of real estate, for example, but the law prevents judicial enforcement of the agreement.

These two varieties of mandatory rules illustrate the dual nature of freedom of contract. One element of freedom of contract is the ability to freely agree to terms; the second element is the judicial power to enforce the terms. Mandatory rules that impinge upon the first type of contract are universally based on public policy, because freedom of contract is completely curtailed. Mandatory rules of the second type, however, may be based on a mix of public policy and commercial practice. A contract rule setting boundaries outside of which provisions will not be enforced must set those boundaries based on the intersection of public policy and accepted practice. The law of liquidated damages balances those interests, and the boundary has changed as common accepted practice has changed.

Liquidated damages is a mandatory rule of the second variety because parties may enter an agreement stipulating excessive damages, but courts will refuse to enforce that term. Compare liquidated damages to the statute of frauds, an emblematic mandatory rule. Under the statute of frauds, oral contracts for the sale of real property are generally unenforceable. The statute of frauds operates in the following steps in an agreement to sell land: (1) The parties enter an oral contract for the purchase of land; (2) one party refuses to perform the contract; (3) the other party petitions the court to enforce the contract; (4) the court looks to the contract and determines that it falls under the statute of frauds, and must therefore be evidenced by a writing; and (5) be-

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CORBIN ON CONTRACTS § 1377 (1962 ed.) (section title: "A Bargain May be Unenforceable without Being Illegal"); SIR FREDERICK POLLOCK, PRINCIPLES OF CONTRACT: A TREATISE ON THE GENERAL PRINCIPLES CONCERNING THE VALIDITY OF AGREEMENTS IN THE LAW OF ENGLAND 9, 287 (8th ed. 1911) ("An agreement or other act which is void has from the beginning no legal effect at all.").

74. Macneil, supra note 48, at 495.
76. Macneil, supra note 48, at 495.
77. Id.; 15 GIESEL, CORBIN ON CONTRACTS, supra note 73, § 79.4, at 20-21.
78. 15 GIESEL, CORBIN ON CONTRACTS, supra note 73, § 79.4, at 20-21.
79. Mattei, supra note 50, at 430 ("Freedom of contract can be limited in many ways, some of which are compatible or mandated by the efficiency criterion.").
cause the term does not fall under one of the statute's exceptions, the contract is deemed unenforceable.81

Analogous steps apply in the operation of liquidated damages law: (1) the parties enter a contract that includes a liquidated damages clause bordering on a penalty; (2) one party breaches and refuses to pay the damages defined by the contract; (3) the non-breaching party petitions a court to enforce the clause; (4) the court looks to the clause and determines that it is a liquidated damages clause (regardless of how the parties name it); and (5) because the clause fails certain requirements — for example the reasonableness requirement and the difficult-to-estimate requirement —, the clause is deemed unenforceable. Liquidated damages rules are always mandatory.82

III. LIQUIDATED DAMAGES UNDER THE COMMON LAW AND UNDER MONTANA'S STATUTORY REGIME

A. The Common Law Rule

Historically, the common law considered three inquiries to determine whether a clause is an allowed liquidated damages clause or a prohibited penalty: (1) the intent of the parties; (2) the difficulty of estimating or proving damages; and (3) whether the amount stipulated is a reasonable forecast of probable damages.83 The salience of each element has fluctuated during the history of liquidated damages law, but over time, the dispositive question has shifted from intention to reasonableness.

Treatises and liquidated damages case law indicate three doctrinal periods (two major periods sandwiching one minor period).84 In the early phase, courts focused mainly on the intentions of the parties — often determined by the language of the contract — and enforced liquidated damages clauses somewhat liberally.85

81. Id.
82. See infra Section V.C. for further discussion of default and mandatory rules.
83. 11 CORBIN ON CONTRACTS, supra note 41, § 58.5, at 419; 3 Farnsworth, supra note 6, § 12.8, at 305. The reasonableness test normally looks forward to what would be reasonable damages at the time of formation rather than at the time of breach.
84. But see 11 CORBIN ON CONTRACTS, supra note 41, § 58.4, at 413 (dividing the historical case law and doctrinal periods differently).
85. Scott & Triantis, supra note 47, at 1443; McCormick ON DAMAGES, supra note 38, §149, at 606 ("Formerly the validity of agreements was said to depend on whether the intention of the parties was to agree on liquidated damages or to fix a penalty [but] [t]his gave too great decisiveness to the descriptive items used in the contract."). See, e.g.,
The middle transitional phase may have been more of a doctrinal cul-de-sac than a phase, characterized by hostility toward liquidated damages clauses. Courts showed their hostility by applying strict tests rather than principles in order to block liquidated damages claims; the intention of the parties was no longer dispositive. During this phase courts looked at the reasonableness of the damages, but sometimes focused on whether damages were difficult to estimate at the time the contract was formed. David Dudley Field was one highly influential writer who focused on the difficulty of estimating damages, even then the least important element of liquidated damages law. Thus Montana law was frozen in a doctrinal dead-end. In his venerable treatise on damages, Charles T. McCormick debunked the difficult-to-estimate element and described how it became the dispositive question in some states:

This supposed requirement of uncertainty of actual damages which in practice has little importance in the other states unfortunately was crystallized in statutory form in California in 1872 (reflecting the tendency then prevailing to frown upon liquidated damages) . . . . This legislation has been embodied also in the Codes of other Western States [including Montana's].

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Gainesford v. Griffith, (1679) 85 Eng. Rep. 59, 65-66 note 1(d) (K.B.) ("The law, nevertheless, remains unshaken, that parties may, by their mutual agreement, settle the amount of damages, uncertain in their nature, in respect of the performance or omission of a particular specified act, at any sum upon which they may agree; and such sum may be recovered as liquidated damages."); Smith v. Smith, 4 Wend. 468, 468 note a (N.Y. 1830) ("One of the rules . . . is, that where it is agreed that if a party do a particular thing a stipulated sum shall be paid by him, there the sum stated may be treated as liquidated damages."); Bagley v. Peddie, 16 N.Y. 469, 471-72 (Ct. App. 1857) (Shankland, J.) ("The effort of the court is to learn the intent of the parties."). In other early cases, however, courts did not defer to the parties' language. See, e.g., Jaquith v. Hudson, 5 Mich. 123 (1858) ("The court will . . . disregard the express stipulation of the parties, only [when] the principle of compensation has been disregarded. . . . [b]ut the real question [is] not what the parties intended, but whether the sum is, in fact, in the nature of a penalty."); Lampman v. Cochran, 16 N.Y. 275, 278 (Ct. App. 1858) ("The parties . . . must be regarded as having given a wrong name to this sum of $500, and that it is in substance a penalty and not liquidated damages."); 11 CORBIN ON CONTRACTS, supra note 41, § 58.4, at 413.

86. See, e.g., FIELD CIVIL CODE § 831 cmt., at 255 (1865) ("The courts . . . constantly discourage [liquidated damages clauses]. They are oppressive and unconscientious, except in the cases permitted above, and ought not to be allowed."); Justin Sweet, Liquidated Damages in California, 64 CAL. L. REV. 84, 142 (1972); 11 CORBIN ON CONTRACTS, supra note 41, § 58.4, at 413.


88. MCCORMICK ON DAMAGES, supra note 38, § 148, at 606 (citing CAL. CIV. CODE §§ 1670, 1671 (Deering 1872); MONT. REV. CODE §§ 5054, 5055 (1907); OKLA. REV. LAWS
In the third phase, prevailing today, courts look primarily, or perhaps entirely, to the third doctrinal question: the reasonableness of the stipulated damages.\textsuperscript{89} Courts still consider the difficulty of estimating damages, but only in relation to the reasonableness of the amount stipulated, not as a separate threshold question. The first doctrinal question — the parties’ intent — is usually no longer even considered relevant.\textsuperscript{90} In the third phase, strict rules are abandoned; reasonableness is the guiding principle rather than some black letter rule.\textsuperscript{91}

The middle phase common law rule prevalent in 1895, when the Montana Legislature enacted Montana’s liquidated damages statute, was restated in 1932 by the American Law Institute in section 339 of its \textit{Restatement of Contracts (First Restatement)}:

Liquidated Damages and Penalties.
(1) An agreement, made in advance of breach, fixing the damages therefor, is not enforceable as a contract and does not affect the damages recoverable for the breach, unless

(a) the amount so fixed is a reasonable forecast of just compensation for the harm that is caused by the breach, and

(b) the harm that is caused by the breach is one that is incapable or very difficult of accurate estimation.\textsuperscript{92}

Under the \textit{First Restatement} rule quoted above, liquidated damages clauses were presumed unenforceable unless two separate requirements were satisfied: the reasonableness requirement of

\begin{itemize}
  \item \textsuperscript{89} McCormick on Damages, supra note 38, § 149, at 606. See 3 Farnsworth, supra note 6, § 12.18, at 308-09 n.26 for discussion of jurisdictions that presume liquidated damages clauses unenforceable and jurisdictions that presume them enforceable. The central inquiry in the modern rule — the reasonableness requirement — was considered by certain courts since at least the early nineteenth century. See, \textit{e.g.}, Smith, 4 Wend. at 468 n.a ("If the amount [of stipulated damages] is excessive and unreasonable, the parties are relieved from their own improvidence, the sum is treated as a nominal penalty."); Williams v. Dakin & Bacon, 22 Wend. 201, 211 (N.Y. Ct. of Error 1839) ("Where the intent of the parties is unclear, the courts have taken the reasonableness of the provision as liquidated damages into consideration, for the purpose of determining whether the [the stipulated damages clause was intended as a penalty].").
  \item \textsuperscript{90} 3 Farnsworth, supra note 6, § 12.18, at 313 ("[Courts’ consideration of parties’ intent in a damages clause is] fast disappearing, and there is no good reason why a stipulation should not be upheld as one for liquidated damages even though its purpose may have been compulsion."); 11 Corbin on Contracts, supra note 41, § 58.5, at 419; Clarkson, Miller & Muris, supra note 53, at 353.
  \item \textsuperscript{91} 11 Corbin on Contracts, supra note 41, § 58.4, at 413.
  \item \textsuperscript{92} Restatement of Contracts § 339 (1932); see also, \textit{e.g.}, Wise v. United States, 249 U.S. 361, 365 (1919); New Britain v. New Britain Tel. Co., 50 A. 881, 884 (Conn. 1902); Banta v. Stamford Motor Co., 92 A. 665, 667 (Conn. 1914).
\end{itemize}
subsection (a) and the difficult-to-estimate requirement of subsection (b).

The prevailing rule changed significantly after the First Restatement. Fifteen years later in 1947, the U.S. Supreme Court in Priebe & Sons, Inc. v. United States cited the First Restatement, but enunciated a more modern rule: "When [liquidated damages clauses] are fair and reasonable attempts to fix just compensation for anticipated loss caused by breach of contract, they are enforced."[^93] The Court did not mention the difficult-to-estimate element, although the sources cited by the Court include it.[^94]

The 1981 Second Restatement, section 356 reads:

Liquidated Damages and Penalties.

(1) Damages for breach by either party may be liquidated in the agreement but only at an amount that is reasonable in the light of the anticipated or actual loss caused by the breach and the difficulties of proof of loss. A term fixing unreasonably large liquidated damages is unenforceable on grounds of public policy as a penalty.[^95] The Second Restatement modern rule presumes liquidated damages clauses enforceable rather than unenforceable. Whereas the First Restatement rule requires an enforceable liquidated damages clause to pass a two-element test, the Second Restatement test has only one element: the stipulated damages must reasonably approximate anticipated or actual loss.[^96] The newer rule no longer includes the First Restatement's requirement that the damages be "very difficult of accurate estimation." The parties' intent, touchstone of the law during the first phase of liquidated damages law, is no longer relevant.[^97]

Although no longer a separate element, the difficulty of determining damages has not disappeared entirely from the equation. What had been the difficulty of estimating damages (First Restatement) became the difficulty of proving them (Second Restatement). The difficult-to-estimate element became the difficult-to-prove factor. The difficult-to-prove factor was also subsumed by the reasonableness inquiry. Under the modern rule, the difficulty of proof only affects the question of reasonableness; it is not a threshold determination in its own right. The comments to the

[^94]: Id.
[^96]: Id. The Second Restatement's rule explicitly broadens the inquiry by applying principles rather than formal tests to determine enforceability.
[^97]: 3 FARNSWORTH, supra note 6, § 12.18, at 313.
Second Restatement describe how the difficult-to-prove factor affects reasonableness:

The greater the difficulty either of proving that loss has occurred or of establishing its amount with the requisite certainty, the easier it is to show that the amount fixed is reasonable. . . . If the difficulty of proof of loss is great, considerable latitude is allowed in the approximation of anticipated or actual harm. If, on the other hand, the difficulty of proof of loss is slight, less latitude is allowed in that approximation.98

In the Uniform Commercial Code (UCC), the difficult-to-prove factor of the Second Restatement has shrunk even further. Although earlier UCC versions copied the Second Restatement's difficult-to-prove factor, the 2003 revision removes that factor entirely except when courts consider consumer contracts. The underlined portion of the new UCC section shows the new language that further removes the difficult-to-prove factor from the consideration.

Damages . . . may be liquidated in the agreement but only at an amount that is reasonable in the light of the anticipated or actual harm caused by the breach and, in a consumer contract, the difficulties of proof of loss, and the inconvenience or non-feasibility of otherwise obtaining an adequate remedy.99

The law has grown increasingly tolerant of liquidated damages clauses for several reasons.100 First, because of the proliferation of adhesion contracts, such clauses have become increasingly widespread in modern commerce.101 Merchants rely on contract terms such as liquidated damages clauses to reduce the probability or expense of litigation. Second, the emerging doctrine of unconscionability — dormant or at least toothless at the genesis of liquidated damages law — limits some of the abuses liquidated damages law was designed to prevent (although a “not-unconscionable” measure of damages presents a substantially lower hurdle to enforcing a damages term than does a “reasonable” measure of damages).102

100. Some theorists have argued that liquidated damages clauses should be enforceable, subject only to the unconscionability doctrine. See supra Section II.B.; Dimatteo, supra note 10, at 637 (discussed infra Section IV.B.); Schwartz & Scott, supra note 72, at 616-17.
101. Slawson, supra note 10, at 529; Dimatteo, supra note 10, at 633-34.
102. 3 Farnsworth, supra note 6, § 12.18, at 303 (“With the development of a doctrine of unconscionability capable of coping with abusive stipulated damage provisions in the same way as other abusive provision, however, it has become increasingly difficult to justify the peculiar historical distinction between liquidated damages and penalties.”). But see 11
Third, the difficult-to-estimate requirement has long been recognized as illogical and counterproductive. Scholars have argued that if damages are easy to estimate, then the parties’ liquidated damages clause is more likely to be accurate, and contracting parties will be better able to determine if the clause is in their interest. Requiring that damages be difficult to estimate deprives many contracts of the benefit of a liquidated damages clause. Scholars arguing this point claim that courts should be more—not less—inclined to enforce liquidated damages clauses when the damages were easy to determine at the time the contract was formed.

B. Montana’s Statutory Regime

Montana’s enactment of the Field Civil Code’s liquidated damages statute crystallized nineteenth century hostility to liquidated damages and deadened the law to changing commercial practices. Penned by Field prior to 1865, Montana Code Annotated section 28-2-721 provides:

**When provision fixing liquidated damages valid.**

(1) Every contract by which the amount of damage to be paid or other compensation to be made for a breach of an obligation is determined in anticipation thereof is to that extent void, except as expressly provided in subsection (2).

(2) The parties to a contract may agree therein upon an amount which shall be presumed to be an amount of damage sustained by a breach thereof when, from the nature of the case, it would be impracticable or extremely difficult to fix the actual damage.

Why does Field’s version lack the reasonableness element of the common law rule, considered most important by most judges and treatise writers? There are three possible explanations. First, Field may have simply erred when he codified this particular rule of the common law; second, Field may have copied some

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**CORBIN ON CONTRACTS, supra note 41, § 58.1, at 396 (arguing that unconscionability is a foundation of the law of liquidated damages, rather than a doctrine rendering liquidated damages law redundant).**

103. See, e.g., McCORMICK ON DAMAGES, supra note 38, § 148, at 605 (“If the agreement reasonably approximates the probable damages which a court would give, why forbid the parties thus to agree, even if the damage could be readily and exactly foreseen?”).

104. Id. § 148, at 603, 605.

105. MONT. CODE ANN. § 28-2-721 (2005). The statute’s use of the term “void” in the statute is confusing. Generally, void contracts are illegal. Liquidated damages clause are not illegal, but may be unenforceable. See 11 CORBIN ON CONTRACTS, supra note 41, § 58.4, 412 (“Although penalties are unenforceable, they are not illegal . . . .”); ARTHUR LINTON CORBIN, CORBIN ON CONTRACTS § 1377 (1962 ed.) (section title: “A Bargain may be Unenforceable without Being Illegal”).
version of the common law rule of the early nineteenth century that lacked an explicit reasonableness requirement; third, Field may have intended that the reasonableness element in liquidated damages would be addressed by the general reasonableness-of-damages statute at section 1858 of the Civil Code\(^\text{106}\) (identical to Montana Code Annotated section 27-1-302).\(^\text{107}\)

Montana courts have not invoked section 27-1-302 for the reasonableness requirement for liquidated damages.\(^\text{108}\) Instead, Montana courts have imputed the reasonableness requirement to the one-element, difficult-to-estimate liquidated damages statute. In *Morgen & Oswood Construction Co. v. Big Sky of Mont., Inc.*, the court borrowed the reasonableness element from an Oklahoma case interpreting the identical Civil Code statute.\(^\text{109}\) The Oklahoma case, in turn, also ignored its own Civil Code reasonableness-of-damages statute when it interpreted a reasonableness requirement into the same Civil Code liquidated damages statute.\(^\text{110}\) The *Morgen & Oswood* court also noted a law review article that claimed that California courts imputed a reasonableness test into its Field Civil Code one-element liquidated damages statute rather than applying California's reasonableness-of-damages statute.\(^\text{111}\)

\(^{106}\) Field Civil Code § 1878, at 581 (1865).

\(^{107}\) "Damages to be reasonable. Damages must in all cases be reasonable, and where an obligation of any kind appears to create a right to unconscionable and grossly oppressive damages contrary to substantial justice, no more than reasonable damages can be recovered." Mont. Code Ann. § 27-1-302 (2005).

\(^{108}\) Perhaps Montana courts and practitioners have not recognized section 27-1-302 as a component of liquidated damages because the title of section 28-2-721 contains the phrase "liquidated damages." Having found the appropriately titled statute, one might be tempted to call off the search for an applicable statute. Any logical ordering of code sections is liable to become jumbled in the process of enactment and re-codification by state legislatures. Professor Burnham wrote that common law rules "make sense only in the context of the common law, not when ripped from that context [and codified]." Burnham, *Let's Repeal the Field Code!*, supra note 5, at 47.


\(^{110}\) Waggoner, 408 P.2d at 769.

\(^{111}\) Morgen & Oswood Constr. Co., 171 Mont. at 272-273, 557 P.2d at 1020 (citing Justin Sweet, *Liquidated Damages in California*, 64 Cal. L. Rev. 84, 131 (1972)). Professor Sweet, describing a liquidated damages statute identical to Montana's, argued that California's "reasonable test" was different from the *First Restatement*'s reasonableness test. California courts required that there be "reasonable endeavor to estimate actual damages." Sweet, *supra*, at 142. This approach was adopted by the Montana Supreme Court in *Weber v. Rivera*. Weber, 255 Mont. 195, 200, 841 P.2d 534, 537 (1992), abrogated by Klyap, 2003 MT 294, 318 Mont. 103, 79 P.3d 250. Justice Nelson, in overruling Weber, pointed out that
The codification of liquidated damages law caused the less important element to engulf the primary element, even as the difficulty of estimating damages faded from the common law rule. In his treatise on damages, McCormick noted the decreasing importance of the difficult-to-estimate requirement: "There seems to be no real reason for imposing this limitation, in addition to the requirement of reasonableness, upon the enforcement of agreements for liquidated damages." By neglecting reasonableness, the primary element of liquidated damages, the Field Civil Code statute failed to accurately codify the common law rule it was supposed to mimic. While the common law adapts to changing commercial practice, Field's statute stands unchanged, cemented in place: a monument to outdated commercial norms. Modern norms and Field's aged rule collided in Klyap.

IV. MONTANA CASE LAW: ARROWHEAD SCHOOL DISTRICT NUMBER 75 v. KLYAP

A. Klyap

Until 2003, most confusion in Montana case law revolved around ambiguities in the language of the liquidated damages statute. In 2003, a majority of the Montana Supreme Court in Klyap discussed the conflicting holdings in the body of liquidated damages case law and then essentially overruled them all. In doing so, the court impliedly nullified section 28-2-721, the liquidated damages statute.
Klyap concerned an employment contract that required a teacher to pay damages to his school district employer if he breached his contract by quitting before the end of the contract term.\textsuperscript{118} The teacher (Klyap) breached the contract. After deciding that the clause was indeed a liquidated damages clause, the Montana Supreme Court banished the controlling statute — section 28-2-721 — to a footnote.\textsuperscript{119} Justice Nelson's majority opinion enunciated a new test for the enforceability of liquidated damages clauses, although neither party had proposed or briefed a new test. Henceforth, only unconscionable liquidated damages clauses would be unenforceable.\textsuperscript{120}

To prove unconscionability, the party opposing a liquidated damages clause must prove first that it signed a contract of adhesion with no meaningful opportunity to dicker over terms, and second, that the contract's terms were unfairly advantageous to the drafter.\textsuperscript{121} The court held that Klyap's employment contract was indeed a contract of adhesion, but was not unfairly advantageous to the school board.\textsuperscript{122} Accordingly, the contract was not unconscionable, and the liquidated damages clause was enforceable against Klyap.\textsuperscript{123} The Montana Supreme Court, unlike the district court, did not consider whether the damages were difficult to estimate or determine at the time the contract was formed.\textsuperscript{124}

prove. However, this section was adopted in 1895 from the Field Civil Code and consequently does not reflect the modern principle that parties in any type of situation can agree to liquidated damages as a matter of freedom of contract." \textit{Id. See infra} note 124.

\begin{itemize}
    \item \textsuperscript{118} \textit{Klyap}, \textsuperscript{5} n.2.
    \item \textsuperscript{119} \textit{Id.} \textsuperscript{24} n.7; \textit{Burnham, Let's Repeal the Field Code!, supra} note 5, at 46.
    \item \textsuperscript{120} \textit{Klyap}, \textsuperscript{5} 54.
    \item \textsuperscript{121} \textit{Id.} \textsuperscript{48}.
    \item \textsuperscript{122} \textit{Id.} \textsuperscript{59-67}.
    \item \textsuperscript{123} \textit{Id.} \textsuperscript{72}.
    \item \textsuperscript{124} Chief Justice Gray's dissent argued that the majority opinion "leaves the liquidated damages statute and . . . case law far behind, and creates an entirely new approach to liquidated damages by incorporating . . . 'cases from other jurisdictions and academic writing on the subject' . . . [which is particularly inappropriate because neither] party argued or briefed this approach . . . ." \textit{Klyap}, \textsuperscript{80-81} (Gray, C.J., dissenting). \textit{Contra} \textit{id.} \textsuperscript{24} n.7 (majority opinion) ("Because, as we discuss below, the instant case qualifies as a situation where damages are impractical or extremely difficult to prove, we need not address this potential problem with § 28-2-721."). The majority opinion claimed that the inquiry into whether the clause was in the parties' "reasonable expectations" incorporated the difficult-to-estimate question and therefore did not leave the statute far behind. \textit{Id.} \textsuperscript{28} 23. Justice Nelson repeated that claim in his special concurrence to his majority opinion. \textit{Id.} \textsuperscript{88} (Nelson, J., specially concurring).
\end{itemize}
B. The Unconscionability Test

The new test in *Klyap* effectively nullified section 28-2-721, eliminated the difficult-to-estimate requirement, and substantially altered the reasonableness requirement. While the statute held liquidated damages clauses presumptively void and unenforceable unless “it would be impracticable or extremely difficult to fix the actual damage,” the *Klyap* test holds liquidated damages clauses presumptively enforceable unless the clause is unconscionable. The court lowered the Second Restatement’s “reasonable” standard to merely “not unconscionable,” a standard that all contract terms must already meet under the doctrine of unconscionability.

The *Klyap* majority adopted the unconscionability test for liquidated damages in part on the basis of several law review articles. In *A Theory of Efficient Penalty: Eliminating the Law of Liquidated Damages*, Professor Larry Dimatteo argues that the ancient ban on penalties should be loosened, and that efficient contract penalties should be enforced. Dimatteo defines efficient penalties as any and all that are not unconscionable. Under Dimatteo’s proposed liquidated damages rule, only inefficient penalties are banned. The doctrine of unconscionability already protects contracting parties against unconscionable liquidated damages clauses, so liquidated damages law becomes redundant.

The efficient penalty doctrine and the unconscionability test revolutionize contract remedies jurisprudence. Under Dimatteo’s proposal, the separate law of liquidated damages disappears (hence the subtitle: “Eliminating the Law of Liquidated Damages”). By adopting the unconscionability approach, the Montana court breached the centuries-old wall of separation between damages and penalties in Anglo-American contract law, allowing courts to enforce any penalty that is not unconscionable.

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126. *Klyap*, ¶ 54.
127. *Id.*, ¶¶ 23, 49.
129. Joseph Perillo calls Dimatteo’s proposal a “sea change in approach” to liquidated damages. 11 *Corbin on Contracts*, *supra* note 41, § 58.1, at 396 n.2.
130. Scholars have advocated breaching the wall between damages and penalties, but have been unsuccessful in changing the law (except perhaps in Montana). *See supra* note 53.
C. Effects of Departing from the Language of the Statute

The court's unconscionability standard leaves the plain language of the statute far behind. 131 When courts "interpret" a statute contrary to its obvious meaning, any potential advantage of codification disappears. Field and his codifying cohorts argued that codification makes the law more accessible to lawyers and the lay public alike by condensing the law into organized and easily accessible volumes. 132

Liquidated damages, and the Klyap opinion in particular, illustrate how the Field Code makes the law inaccessible. Instead of accessibility, the plain language of the statute now actively misleads a reader. A glance at the bold "liquidated damages" heading of section 28-2-721 tells a reader that the statute governs liquidated damages clauses. Without delving into the case law, a reader would not realize that the reasonableness of damages is a critical element of an enforceable liquidated damages clause. Furthermore, a post-Klyap reader of the statute would never guess that any "not unconscionable" liquidated damages clause is enforceable. Any reasonable reader would understand the code section to mean that liquidated damages clauses are presumptively unenforceable unless the damages are "impracticable or extremely difficult to determine." Reasonable readers are likely to misconstrue the nature of Montana's liquidated damages law by reading the statute.

The rules governing liquidated damages parse damages from penalties. Where the line is drawn between the two is governed not only by a fixed conception of public policy, but also by notions of commercial reasonableness. Thus liquidated damages — a mandatory rule — is also influenced by common commercial practices as are default rules. Codifying a rule dependent on common or commercial practices robs the rule of its most important quality: flexibility. 133 Like most default rules, the mandatory rule of liquidated damages must be able to adapt to changing practice to fulfill its function: drawing the appropriate line between damages and penalties.

131. Klyap, ¶ 80 (Gray, C.J., dissenting).
132. Morriss et al., Debating the Field Civil Code, supra note 26, at 389.
133. See Burnham, Let's Repeal the Field Code!, supra note 5, at 44, 47; Morriss, "This State Will Soon Have Plenty of Laws," supra note 27, at 363-64; Robert G. Natelson, Running with the Land in Montana, 51 Mont. L. Rev. 17, 43-44 (1990) (discussing how statutes from Montana's Field Civil Code affect property law, another area of law traditionally governed by the common law).
Although *Klyap* apparently eliminated the legal effect of section 28-2-721, practitioners may be tempted to continue to cite to the statute's language because it has not been repealed. In a common law jurisdiction, cases rendered invalid by a later case are marked by warning symbols in legal databases such as Lexis and Westlaw. The legal database services will not put a warning next to a statute that a court ignores; practitioners must search out the case law for clues that a state's high court ignores a particular statute. The result is law that is less accessible.

The unconscionability test for liquidated damages is a significant innovation in contracts jurisprudence. This innovation occurred not in a state applying the common law, but in Montana, where liquidated damages are governed by statute. Judging from the results of its next significant liquidated damages case, the court may have realized that *Klyap* went too far.

V. MONTANA CASE LAW: *COLE v. VALLEY ICE GARDEN, L.L.C.*

A. Cole I

In 2005, when *Klyap* was less than two years old, the Montana Supreme Court again significantly changed the law of liquidated damages. *Cole v. Valley Ice Garden, L.L.C.* (*Cole I*) presented another post-*Klyap* opportunity for the court to consider a liquidated damages clause. The case concerned an employment contract in which David Cole agreed to coach the Bozeman Ice Dogs hockey team for the team's owner (collectively VIG). The Montana Supreme Court decided *Cole I* on February 9, 2005, mainly on the basis of a novel (and flawed) approach to the law of liquidated damages. After rehearing the case several months later, however, the court withdrew the February opinion and issued a new superseding opinion on May 5, 2005 (*Cole II*). *Cole II* disposed of the case solely on the basis of the appellate standard of review, without addressing the question of liquidated damages at all.

137. Id. ¶ 34-37.
Why analyze a withdrawn opinion, the legal analog of a dead letter? Three reasons. First, the dispositive issue of the superseding opinion was unrelated to the liquidated damages discussion in the first opinion. The court did not specifically disown its Cole I liquidated damages analysis. There is no reason to believe that the court will not imitate the Cole I approach in the next liquidated damages case that arises. As of this writing, the withdrawn opinion is also cited in the Lexis case notes for Montana Code Annotated section 28-2-721 and two other statutes for the court’s waiver application. The case has not yet entirely disappeared.139

Second, the court’s withdrawn opinion illustrates many of the negative effects of Montana’s statutory contract law. Third, the withdrawn opinion included a significant unrecognized legal error: the court mistakenly characterized liquidated damages as a default rule rather than a mandatory rule.

The disputed contract, drafted by Cole’s attorney, required that if Cole was terminated without cause, VIG must pay Cole one year’s salary ($50,000) as damages. If Cole was terminated for good cause, no compensation was due. Under Cole’s coaching, the team’s record worsened and game attendance decreased. When the Ice Dogs lost six of the first seven games of the 1999-2000 season, Cole was fired about four months into a five year contract term.140

In his suit, Cole claimed that VIG breached the contract by firing him without good cause. The trial court agreed and granted summary judgment to Cole on the question of cause for termination. At a bench trial to determine damages, the district judge held that the contract term fixing damages for termination without cause was void under section 28-2-721, Montana’s liquidated damages statute. Therefore, rather than the $50,000 that Cole would have been due under the contract’s liquidated damages clause, the trial court determined that Cole’s expectancy damages totaled almost $200,000 for the remaining term of the employment contract.141

Cole I differs from most liquidated damages cases in that the drafter, the party who was to receive the contract’s liquidated damages, argued against enforcement. In most liquidated damages cases, the party who will be paying the damage clause argues against it.

141. Id.
In its appeal, VIG claimed first that the termination was for good cause, and second, that if termination was without good cause, section 28-2-721 and Klyap set damages at the contract's stipulated amount: one year's salary. In Cole I, a majority of the Montana Supreme Court held that Montana Code Annotated section 28-2-721 (the statute with "liquidated damages" in the title) did not apply to the liquidated damages clause in Cole's contract.¹⁴²

The Cole I opinion studiously avoided discussing Klyap, only mentioning the case once:

VIG argues that... [under section 28-2-721], Cole must prove the provision of the agreement unconscionable under our decision in Arrowhead Sch. Dist. No. 75 v. Klyap... VIG maintains that because the clause was drafted by Cole — a fact not in dispute — [Cole] cannot prove the clause's unconscionability, and that, therefore, the provision is enforceable.¹⁴³

The court's next question should have been: Is the liquidated damages clause enforceable? If the court had asked and answered that question, then Klyap and its unconscionability test would have been clearly reinforced, against the clear language of section 28-2-721. But the Cole I court sidestepped the critical questions regarding the post-Klyap nature of section 28-2-721. The Montana Supreme Court never addressed the trial court's application of the pre-Klyap plain meaning of the statute.

Instead, the court pulled a rabbit out of its hat. The rabbit was one of the Field Civil Code's "maxims of jurisprudence," the "hortatory bromides"¹⁴⁴ ensconced in Article 1 of the Montana Code Annotated. The court applied Montana Code Annotated section 1-3-204 (2003), which reads:

Anyone may waive the advantage of a law intended solely for his benefit. But a law established for a public reason cannot be contravened by a private agreement.¹⁴⁵

The court's novel application of the wavier maxim to liquidated damages was sua sponte: "We conclude that because Cole waived the benefit of the liquidated damages law by virtue of the contract provisions he drafted, the District Court erred in applying the pro-

¹⁴². Id. ¶¶ 34, 37.
¹⁴³. Id. ¶ 32.
¹⁴⁴. Burnham, Let's Repeal the Field Code!, supra note 5, at 32. The Field Civil Code also instructs readers how the maxims of jurisprudence should be used: "Purpose of maxims. The maxims of jurisprudence... are intended not to qualify any of the other provisions of this code but to aid in their just application." Mont. Code Ann. § 1-3-101 (2005).
¹⁴⁵. See Burnham, Let's Repeal the Field Code!, supra note 5, at 50-52 (criticizing the Montana Supreme Court's application of Mont. Code Ann. § 1-3-204 (2005)).
visions of the liquidated damages statute to the contract before us." 146

Professor Scott Burnham described section 1-3-204 and other maxims as generally harmless "pithy sayings[,] . . . but when reduced to black letter law they can cause great mischief." 147 In this case the mischief is compound. The court's application of the waiver maxim was premised on the legal error that the rule governing liquidated damages is a default rule, and the maxim's application also violated a principle of statutory application.

B. Rules of Statutory Application

The court ignored the principle of statutory interpretation — codified in Montana, naturally — that multiple relevant statutes be applied from most specific to most general. Montana Code Annotated section 1-2-102 (2005) provides:

When a general and particular provision are inconsistent, the latter is paramount to the former, so a particular intent will control a general one that is inconsistent with it. 148

Under that directive, the court should have considered whether the parties waived the statute only after deciding whether the clause was enforceable under the liquidated damages statute. Application of the waiver maxim would have been unnecessary if the liquidated damages statute allowed the disputed clause to be enforced.

The Cole I majority opinion dispensed with the specifically relevant law of liquidated damages in far fewer words than it expended on the generalized waiver maxim. (The Klyap court wasted even fewer words on the statute, quoting it only in one footnote, 149 and discussing it in another footnote. 150) The court held that, because Cole bargained for the term and drafted it, the parties waived the statute. Therefore, the clause was enforceable, and Cole should receive the contract's liquidated damages of $50,000, rather than the nearly $200,000 trial court award.

146. Cole I, ¶ 34.
147. Burnham, Let's Repeal the Field Code!, supra note 5, at 32.
148. Id. at 34 (discussing MONT. CODE ANN. § 1-2-102 (2005)).
149. Klyap, ¶ 24 n.6.
150. Id. ¶ 24 n.7.
C. Of Default Rules and Mandatory Rules

The court's second legal error was more serious. In order for any party to "waive the benefit of a law," the law waived must be a default rule rather than a mandatory rule. Mandatory rules may not be waived by contract. As discussed above in Section II. C, the law of liquidated damages is a mandatory rule. The court's waiver application and holding was therefore erroneous.

The court set up the waiver with the following circular argument, concluding that the liquidated damages statute constitutes a default rule:

[The liquidated damages statute] applies in general to contracts entered into between bargaining parties. Moreover, the existence of § 28-2-721(2), in the statutory scheme supports the proposition that it is a law whose provisions are intended for the benefit of — and therefore may be waived by — contracting parties. In other words, the fact that § 28-2-721(2) allows by its provisions the waiver of the benefit of the statute, demonstrates that it is not a law established for a public reason, because such laws cannot be contravened by private agreement.

The court implied that because the statute generally forbids liquidated damages clauses but under some conditions allows them, the rule must be default. The court offered this incorrect assertion without analysis or citation, based only on the "existence of § 28-2-721 (2) in the statutory scheme." The entire liquidated damages holding rests on this language.

In fact, the faulty assertion implodes the entire waiver analysis. Many mandatory rules allow exceptions under which the rule will not apply. Returning to the statute of frauds analogy, an oral contract for the purchase of land may be enforceable, for example, if the party seeking enforcement proves that she acted to her detriment in reasonable reliance on the other party's assurances, and injustice can be avoided only by enforcing the contract by specific performance. The existence of an exception does not convert the statute of frauds into a default rule. Rather the rule sets lim-

152. In the court's defense, Professor Burnham, Montana's preeminent resident contracts scholar, also failed to recognize that the liquidated damages statute enunciates a mandatory rule: "The [Cole I] court correctly determined that section 28-2-721 is not the kind of regulatory [or mandatory] rule that parties cannot waive. . . . This statute is facilitatory [or a default rule]." Burnham, War Against Arbitration, supra note 14, at 149 n.37 (discussing Cole I).
its within which the parties may freely agree. The limits themselves however, are mandatory.

The default rule measures contract damages by the amount of the non-breaching party’s expectancy interest, determined after breach. By including a liquidated damages clause, contracting parties contract around the default rule of expectancy. The law of liquidated damages erects the mandatory upper boundary that limits the parties’ freedom to contract around the default rule. If the parties’ liquidated damages clause extends beyond that boundary, then the damages will be considered an unenforceable penalty, and the clause will be excised from the contract. Because the rules governing liquidated damages draw the line between damages and penalties, the rules are mandatory. The court’s application of the waiver maxim to liquidated damages rests on a flawed premise.

D. Operation of the Waiver Maxim

The court’s application of the waiver maxim to section 28-2-721 pushes most liquidated damages clauses outside the reach of the liquidated damages statute. By the court’s analysis, the drafter and non-drafter of any bargained-for liquidated damages clause both waive the benefit of the liquidated damages law. In an adhesion contract, however, the non-drafting party by definition had no meaningful opportunity to dicker over terms. Therefore, only the non-drafting party to an adhesion contract would be able to defeat the waiver and invoke the liquidated damages statute under the court’s analysis.

A party thus eluding the waiver maxim may invoke the statute, and must prove unconscionability based on Klyap. The unconscionability test requires that the non-drafter prove: (1) that it had no meaningful ability to bargain for the terms; and (2) that the terms were unfairly favorable to the drafter. Of course, the


156. 3 Farnsworth, supra note 6, § 12.18, at 304 ("[A liquidated damages provision] displaces the conventional damage remedy for breach.").

157. 11 Corbin on Contracts, supra note 41, § 58.4, at 413.

158. See Schwartz & Scott, supra note 72, at 616 (characterizing as a mandatory rule liquidated damages' function to separate penalty from damages).

159. 1 Farnsworth, supra note 6, § 4.26, at 557.

non-drafting party already proved the first of those two steps to show it did not waive the statute.

The Cole I waiver analysis simply took the first step of the Klyap test and renamed it waiver. If the court was satisfied with Klyap, why create an entirely novel means of addressing liquidated damages simply to come to the same result? The court may have been uncomfortable with its recent precedent but was not prepared to disown it. Klyap will be a difficult case to overrule. Klyap essentially overruled all previous liquidated damages case law. If the overruling case is itself overruled, will the now-undead statutes rise from their graves like the zombies in The Night of the Living Dead to wreak havoc upon the living? The Cole I waiver analysis allows a court to resolve most liquidated damages cases without applying the problematic statute. As long as the parties bargained, then Klyap and section 28-2-721 do not apply. Thus Klyap becomes less important. Using the Cole I model, a court can waive first and ask questions later or not at all.

E. Cole II: The Superseding Opinion

Cole I was good law for only about three months. Upon VIG’s motion for rehearing, the Cole I majority apparently realized what Justice Rice had already pointed out in the Cole I dissent: the wrong standard of review had been applied to the question of cause. The court withdrew Cole I, and unanimously decided Cole II.162

In the second opinion, the court held that the Ice Dogs’ losing record was actually good cause for VIG to fire Cole.163 No damages were due, liquidated or otherwise. Because this approach bypassed all damages analysis, the liquidated damages discussion disappeared. The court’s novel application of the maxim of jurisprudence disappeared. The court’s erroneous holding that liquidated damages constitute a default rule disappeared. Everything that made Cole I noteworthy to an observer of contract law officially disappeared.

163. Id. ¶ 1.
VI. Lessons From The Case Law

A. The Field Civil Code Distorts Montana's Contract Law

Decius Wade, widely respected former Montana Territorial Supreme Court Justice, argued forcefully in the 1890s that Montana should adopt Field's Civil Code. In a speech extolling the virtues of codification, Wade proclaimed that "[c]odification . . . was never intended to change the law, its only purpose being to hunt up, gather together and put in form that which the courts have declared to be the law."\(^\text{164}\)

Wade's prediction that the codes would not change substantive Montana law proved incorrect.\(^\text{165}\) Codification in itself changes the law. In the case of liquidated damages, the process of codification caused the less important, difficult-to-estimate prong of the test to subsume the more important reasonableness prong.

Codification also destroys the common law's greatest asset: its flexibility. Statutory contract rules, even when they accurately mimic an analogous common law rule, lack the ability to evolve alongside commercial practice. Most contract rules are meant to facilitate rather than regulate parties' actions.\(^\text{166}\)

Montana's liquidated damages jurisprudence illustrates that mandatory rules also may require the flexibility that is the hallmark of the common law. Mandatory rules that go to enforceability — rather than to the ability to enter contracts — may have a commercial-reasonableness component as well as a public policy component. Therefore, these rules may also need to adjust to changing commercial practice. Justice Nelson's Klyap opinion describes how commercial practice has changed in the area of liquidated damages: "section [28-2-721] was adopted in 1895 from the Field Civil Code and consequently does not reflect the modern principle that parties in any type of situation can agree to liquidated damages as a matter of freedom of contract."\(^\text{167}\)

Professor Burnham argues that the Montana Legislature should repeal Montana's Field Code statutes, except those that are mandatory and those that diverge from the common law


\(^{165}\) Morriss, "This State Will Soon Have Plenty of Laws," supra note 27, at 397-402.

\(^{166}\) Professor Burnham argues that statutory contract rules cause great mischief when used to govern default rules. Burnham, War Against Arbitration, supra note 14, at 146.

rule. The Montana liquidated damages statute is both mandatory and diverges from the common law. Applying Burnham’s criteria, one might be tempted to spare section 28-2-721 from repeal. However, this particular Field Code statute has created as much of a legal mess as any Field Civil Code default rule. Burnham’s formula for repeal was overly restrictive: statutes that diverge from the common law rule may be particularly eligible for repeal because they tend not to follow modern commercial practices. That is particularly true in statutes governing enforceability. Contract statutes that diverge from the common law rule tend to be those that also diverge from common practice and acceptance in other common law jurisdictions.

B. What Montana Practitioners Should Heed from the Montana Supreme Court's Treatment of Liquidated Damages Clauses

Practitioners should probably not rely on Klyap to draft enforceable liquidated damages clauses. Although Westlaw and Lexis indicate no negative treatment, Klyap may not be solid precedent. In Cole I, even though the defendant’s briefs cited Klyap as controlling authority over liquidated damages clauses, the court refused to discuss the case, its most directly on-point precedent. The Cole I court’s reluctance to cite Klyap may signal the court’s discomfort with the unconscionability standard, especially because Klyap would have led to the very same result the Cole I court came to. For contract drafters, the “reasonableness” standard of the common law rule is probably safer than Klyap’s unconscionability standard.

The difficult-to-estimate element of the statute’s plain language shows little signs of life. Although Klyap may not be relia-

168. Burnham, Let’s Repeal the Field Code!, supra note 5, at 63. Burnham criticizes the Field Code at every opportunity. See Morrise et al., Debating the Field Civil Code, supra note 26 (arguing the Field Civil Codes’ negative effects in a debate with Montana Supreme Court Justice James Nelson); Burnham, War Against Arbitration, supra note 14, at 146 n.25 (“I will again say to the Legislature: Repeal the damn thing.”); Burnham, Let’s Repeal the Field Code!, supra note 5 (the exclamatory title says it all).
169. See Klyap entries on Westlaw and Lexis database services.
170. Cole I, ¶ 32.
171. Id.
172. Practitioners should note once again that goods contracts are governed by a separate statute in Montana's version of the UCC: Montana Code Annotated section 30-2-718 (2005). That statute is untested by the Montana Supreme Court as of this writing; it is not clear whether Klyap's unconscionability test was intended to cover goods contracts.
ble precedent, the plain language of the statute may not be either. The pre-2003 cases interpreting the statute according to its plain meaning – requiring that damages be difficult to estimate — were overruled by Klyap. The Montana Supreme Court may be more likely to enforce liquidated damages clauses than the plain language of section 28-2-721 indicates, even if Klyap is not solid precedent.

Cole I and Klyap indicate that the court would prefer a rule of liquidated damages closer to the common law rule. The court found two separate methods of enforcing liquidated damages clauses despite the statute. The first method, used by Klyap's majority, effectively overruled the statute. The second method, used by the Cole I majority, employed the waiver maxim to bypass the statute. Both methods are flawed. Cole I suggests that the court may prefer an approach that sidelines the statute without entirely disregarding it, as the Klyap test did.

Using Cole I as a template, the court may apply the waiver maxim the next time it considers a liquidated damages clause. However, the waiver analysis rests on the false premise that the law of liquidated damages is a default rule. Rather, liquidated damages law sets the mandatory boundaries within which parties are free to contract.

The court's analyses in Klyap and Cole I indicate that the court will hold liquidated damages clauses to a higher standard when the stronger party seeks to enforce the clause against a weaker party in a contract of adhesion. In such a case, the court may return to the plain language of section 28-2-721, requiring the stronger party to prove that the damages were “impracticable or extremely difficult to determine” before holding a liquidated damages clause enforceable.

The court bent over backwards to move Montana law closer to the current common law rule of liquidated damages. First, the Klyap majority openly rejected the plain meaning of the statute and developed a revolutionary new test. Second, the Cole I majority undertook a fundamentally flawed analysis in order to enforce a liquidated damages clause without invoking Klyap. These actions indicate that the court wants to bring Montana's law of liqui-
dated damages in line with most other jurisdictions. The modern commercial norm in most jurisdictions presumes greater enforcement of liquidated damages clauses.

VII. Conclusion

Contract law functions to facilitate commerce and to promote certain public policies. Default rules are built upon generally accepted commercial practice and the standards of commercial reasonableness. Some mandatory rules are based upon a public policy component as well as on the standards of commercial practice and reasonableness. Because commercial practice frequently changes in response to new markets, technologies, and practices, contract law should evolve in order to continue to facilitate commerce.

If contract rules are locked in nineteenth century statutes while commercial practices evolve, statutory contract law may eventually obstruct rather than facilitate commerce. At that point, courts can either enforce a result unreasonable in the circumstances or try to jury-rig an argument with whatever legal material is at hand to reach the reasonable result.

Faced with a Field Civil Code statute that the Montana Legislature has not amended since its enactment in 1895, a statute out of step with current commercial practices and conflicting with most jurisdictions' treatment of liquidated damages, the Klyap and Cole I courts bypassed the statute. The Klyap court brazenly disregarded the statute, while the Cole I court, ignoring Klyap, resurrected some unknown version of the statute only long enough to render it irrelevant in many situations by applying a maxim of jurisprudence.

Montana courts have now attempted two jury-rigged solutions to circumvent the outmoded liquidated damages statute. Both solutions are based on flawed analyses and make dangerous precedent. At this stage, the Montana Legislature is in a much better position to mop up the spilled liquidated damages law than are the courts.

174. Burnham, War Against Arbitration, supra note 14, at 139.