
CHAPTER 6

PENALTY CLAUSES

I. INTRODUCTION

Penalty clauses are extremely common in international contracts. The Working Group was able, without any difficulty, to find a sample of over 100 of them, taken from very different types of contracts: many contracts for the construction of factories or other types of works, but also contracts for services, supply contracts, counter-trade contracts, loan contracts, licensing agreements, etc.

The subject seems perennial, but it has jumped back into the limelight in the recent past. In some countries, the legislation governing penalty clauses has been amended (in France and Belgium, for example) or there have been changes in the case law. There was a Benelux Convention on penalty clauses (never ratified), and a Council of Europe Resolution. The U.N. Commission on International Trade Law (UNCITRAL) has drawn up uniform rules on such clauses. The International Chamber of Commerce has published a practical guide on penalty and liquidated damages clauses.¹ Specific provisions are devoted to them in both the Unidroit Principles on International Commercial Contracts (Article 7.4.13) and in the Principles of European Contract Law (Article 9:509). Generally speaking, a study of penalty clauses in comparative law has much to teach us.²

¹ Guide to Penalty and Liquidated Damages Clauses, International Chamber of Commerce, Publication No. 478, Paris, 1990, 51 pp.

² For penalty clauses in comparative law, see P. Benjamin, Penalties, Liquidated Damages and Penalty Clauses in Commercial Contracts: A Comparative Study of English and Continental Law, 9 *Int. Comp. L. Q.* 1960, pp. 600–627; H. Nial, Les clauses pénales dans les contrats de vente internationaux, in *Etudes juridiques offertes à J. Julliot de la Morandière*, Paris, 1964, pp. 417–420; T. Segré, Clause pénale et dommages ultérieurs en droit comparé, *Rev. Int. Dr. Comp.* 1970, pp. 299–311; Council of Europe, *Clauses pénales en droit civil*, 3 vols of 91, 15 and 14 pp., 1972; G. Treitel, Remedies for Breach of Contract, *Int. Encycl. of Comp. Law*, 1976, Vol. VII, Chapter. 16, Nos. 120–136; J. Thilmany, Fonctions et révisibilité des clauses pénales en droit comparé, *Rev. Int. Dr. Comp.* 1980, pp. 17–54; P. Karrer, Liquidated Damages and Penalty Clauses—A Comparative Study, 1 *The Int. Contract*, 1980, pp. 225–230; D. Fischer, *Vertragsstrafe und vertragliche Schadensersatzpauschalierung*, 1981, 197 pp.; P. Murray, Comparative Analysis of Liquidated Damages and Penalty Clauses, 2, *The Int. Contract*, 1981, pp. 353–358; G. Bucksch, Rechtsvergleich zu Vertragsstrafe und/oder pauschaliertem Schaderersatz, *R.I.W.* 1984, pp. 778–782; F. Loksailer, *La clause pénale dans les contrats internes et dans les contrats internationaux*, Lausanne, 1985, 207 pp.; D.L. Jaffe & K.B. Jaffe, Stipulated Damage Provisions

Moreover, in this area as in others, systematic analysis of clauses drafted by international trade law practitioners is very fruitful owing to the diversity and originality of the techniques it reveals.

The first task is to define the subject and adopt a terminology. *A priori*, a penalty clause can be defined as one stipulating payment of a sum of money in the event of non-performance of a contractual obligation, with a purpose either of pure indemnification or of deterrence.³ The great majority of the clauses considered by the Group come within this definition. However, occasionally, as we shall see, some of the clauses considered stray from it.⁴ Furthermore, we will seek to establish the differences between penalty clauses and certain similar provisions, such as judicial penalties (*astreintes*) or withdrawal payments (*clauses de dédit*).⁵

in France and in the United States, 33 *Amer. J. of Comp. Law*, 1985, pp. 637–672; D. Mazeaud, *La notion de clause pénale*, Paris, L.G.D.J., 1992; U. Draetta, Les clauses pénales et les pénalités dans la pratique du commerce international, *I.B.L.J.*, 1992, pp. 635 et seq.; U. Mattei, The Comparative Law and Economics of Penalty Clauses in Contracts, *Amer. Journ. of Comp. Law*, 1995, pp. 427 et seq.; B. Eggleston, *Liquidated Damages and Extensions of Time*, Londres, Blackwell, 1997; E. MacDonald, *Exemption Clauses and Unfair Terms*, Londres, Butterworths, 1999, 297 pp.; K.P. Berger, Vertragsstrafen und Schadenspauschalierungen im internationalen Wirtschaftsvertragsrecht, *R.I.W.* 1999, pp. 401–411; H. Schelhaas, Waarheen met het boetebeding in Europa? Een analyse van het Engelse, Schotse, Belgische en Nederlandse recht en de Principles of European Contract Law, *Tijdschr. voor Privaatr.*, 2000, pp. 1371–1443; A. Pinto-Monteiro, La clause pénale en Europe, in *Le contrat au début du XXI^{ème} siècle, Etudes offertes à Jacques Ghestin*, Paris, L.G.D.J., 2001, pp. 719–746; Y. Rabier, Liquidated Damages in International Contracts for the Construction of Electric Power Stations, *I.B.L.J.*, 2003, pp. 157–169; L. Miller, Penalty Clauses in England and in France—A Comparative Study, *Int. Comp. L.Q.*, 2004, pp. 79–106.

See also a series of studies drawn up by members of the working group: H. Grigera Naon, La clause pénale en droit argentin, *D.P.C.L.*, 1982, pp. 443–445; J. Thilmany, La clause pénale en droit belge, *id.*, pp. 447–462; D. Françon, La clause pénale en droit français, *id.*, pp. 481–490; G. Schiavoni, La clause pénale en droit italien, *id.*, pp. 491–492; M. Strauch, La clause pénale en droit allemand, *id.*, pp. 499–506; L. Arentz-Hansen, International Contracts—Penalty Clause According to Norwegian Law, *id.*, pp. 493–497; B. Cremades, La clause pénale en Espagne et en Amérique Latine, *id.*, pp. 463–481; P. Ellington, Penalty Clauses in English Law, *id.*, pp. 507–514; B. Hanotiau, La clause pénale en droit américain, *id.*, pp. 515–524.

³ The problem of defining penalty clauses will be taken up again *infra*, pp. 335–341, when they will be compared to certain similar provisions.

⁴ Cf. *infra*, pp. 310–311 and 326.

⁵ Cf. *infra*, pp. 335–341.

Penalty clauses also have to be distinguished from “punitive damages” which can be awarded by courts in some legal systems, but which will not be considered here; cf. B. Cremades, Liquidated Damages, Penalty Clauses and Punitive Damages within International Contracts, *I.B.L.J.*, 2002, pp. 329–345.

As regards terminology, the expression “penalty clause,” in its broad meaning, will be used in this chapter, for reasons of simplicity. However, one shall be alert to the fact that certain legal systems use different expressions depending on whether the purpose of the clause is to indemnify or to punish. In English law, for example, the expression “liquidated damages” refers to clauses of the former kind, while “penalty” is used in the latter case. The distinction is important in common law countries, as penalties are considered as void while there is no doubt about the validity of liquidated damages clauses.

In the first part of the chapter (Section II), we will set out the main findings emerging from our analysis of the sample of clauses under consideration. In the second part (Section III), we will share some thoughts, first of all on the practice relating to penalty clauses in international contracts (by comparing in particular the group’s observations and those of UNCITRAL) and on the main legal problems encountered in practice.

II. PRACTICE

A. Analysis

There are three possible ways of setting out the analysis. First, clauses can be considered according to the type of contract from which they are taken (for example, penalty clauses in contracts for sale, construction contracts, loan agreements, licensing agreements, etc.). Secondly, they can be classified according to the type of breached obligation that they seek to penalize (for example, clauses penalizing delay, failure to supply, inadequate performance, the breach of an undertaking not to resell, etc.). Thirdly, the different technical aspects of the clauses considered can be classified (for example, problems with the basis of calculation, rates to be applied, exempt amounts, arrangements for payment, etc.).

The second criterion appeared to be the one most likely to illustrate with clarity the practice dealing with penalty clauses in international contracts, and thus it is the one we chose. There are more similarities and shared particular characteristics among penalty clauses penalizing breaches of the same obligation, for example late performance, in different types of contract, than among penalty clauses included within the same contract, but penalizing breaches of different obligations. As for the third possibility, if we had adopted it, the minute dissection of clauses would not have revealed the sometimes very complex systems set up by those drafting the contracts.

Therefore, it is mainly according to the type of obligation to which the penalty clauses relates that our analysis will proceed. The two other criteria cannot, however, be totally disregarded. First of all, they will reappear

when we look at any sub-classifications; and they will be referred to again on several occasions in the latter part of our study.

We shall look in succession at clauses penalizing delay, inadequate performance, failure to supply, breach of an undertaking to purchase, failure to defend industrial property rights and failure to comply with certain undertakings to refrain from acting.

1. *Late Performance*

Failure of the duty to perform the contract on time is probably the most commonly penalized offense. It seems that this is systematically the case in building contracts, but such clauses are also frequently found in other types of agreements.

(a) Construction Contracts. Clauses penalizing late performance are extremely common in construction contracts, where they achieve the highest degree of sophistication.⁶

1. *Hypothesis—Imputability.* The hypothesis is one of delay in performance with respect to contractual obligations:

- “If the contractor fails to complete the construction supply, erection, operation, maintenance or any of them within this period stipulated in Article Twenty-Two of these conditions, or within the period fixed . . .”
- “If the contractor should fail to complete and deliver the Works and/or to render and accomplish the Services in full on the specified Dates of Completion of each contractual Task . . .”

The clause sometimes specifies that the late performance must be imputable to the party under the duty to perform:

- “Pour tout retard imputable au constructeur dans l’achèvement des travaux d’infrastructure du complexe industriel tel qu’il est prévu au planning contractuel de réalisation figurant à l’annexe G aux présentes . . .”
- “In the event that, except for reasons due to K or to force majeure, or other similar events beyond the control of A, the beginning of reception tests is delayed beyond the contractual delivery date . . .”

The following clause highlights the need for a causal link between the event allegedly constituting *force majeure* and its exculpatory effect:

⁶ On this point, see also the study carried out by Th. De Galard, *Les pénalités de retard dans les contrats internationaux de construction*, *I.B.L.J.*, 1986, pp. 131–143.

“Les pénalités de retard ne seront pas appliquées dans les cas de force majeure. Le cas de force majeure est seulement admis dans l'éventualité d'une répercussion obligatoire sur les délais de fourniture.”

Another clause does not merely exonerate the builder in the event of late performance imputable to the client; it makes the client, in such a case, liable to the builder, which is a mere restatement of the normal legal solution:

“Toutefois si un retard dans l'achèvement de la mission du constructeur telle qu'elle est prévue au Planning Contractuel de Réalisation était imputable exclusivement à M.O. et créait un préjudice direct pour le constructeur, M.O. indemniserait le constructeur pour le préjudice direct qu'il aurait subi.”

Clearly this last clause is not a penalty clause, since it does not specify the amount of compensation in advance.

However, certain provisions are very harsh on the builder. In the following example, taken from the general conditions of the Egyptian railways, it is interesting to note the discretion that the client reserves for himself, both as to the nature of the underlying event and its effects:

“If it is proved to the satisfaction of the Organization, whose decision will be final, that the whole or the part of the delay arises from causes of “Force Majeure” such as strikes, shipwrecks . . . etc, the Organization may waive the right to enforce the penalty in whole or in part.”

If the indemnity for late performance clause is silent on the question of imputability, the answer is probably to refer either to the solutions offered by the ordinary law applicable to the contract,⁷ or to the provisions of the contract that cover exemption clauses generally.⁸ The following clause seems to penalize the supplier “whatever the reason for the late performance,” but it does not rule out *force majeure* in actual fact: it makes an express reference to Article 2.4 of the contract, which provides for an extension of the time limits, without compensation, in the event of *force majeure*:

“En cas de dépassement des délais contractuels fixés dans le Marché ou prorogés dans les conditions prévues à l'article 2.4, le fournisseur est passible de pénalités, quelle que soit la cause du

⁷ On that point, it is worth noting that in certain legal systems, in particular under *common law*, contractual liability is interpreted much more strictly than in others.

⁸ On this point, cf. Chapter 8, on *force majeure* clauses.

retard et sans qu'il soit besoin d'aucune notification préalable, la seule échéance du terme le constituant en demeure."

2. *Differentiated Clauses.* Some contracts include a set of clauses penalizing, in various ways, a contractor's late performance in carrying out his various obligations:

"14.1. Dédommagements pour retards dans la fourniture des documentations . . .

"14.2. Pénalités pour le retard de livraison des machines, du montage et de la réception . . .

"14.3. Pénalités pour le retard de livraison des pièces de rechange . . .

"14.4. Pénalités pour le retard des délais de livraison pour la suppression de défauts . . ."

3. *Exclusions.* Sometimes the contract excludes any compensation for late performance in case of specific obligations:

"The supplies made free of charge by . . . by virtue of Article 3, par. 5, and Articles 12 and 13 shall not be subject to penalties for delay."

4. *Grace Period.* Provision may be made for a grace period:

- "... à l'issue d'une période de grâce initiale de soixante jours . . ."
- "... after a grace period of two weeks . . ."

But what is the position once the grace period has expired? Should compensation be calculated from the initial time limit, or only from the expiry of the grace period? The drafters of clauses do not always consider this alternative, and some forms of wording may lead to serious problems of interpretation. This is not the case for the following clauses, which set out their position explicitly, albeit in two different ways:

- "After the grace period, the delay taken into account for penalty calculation will start from contractual delivery date."
- "Un pour cent du prix des travaux d'infrastructure par mois de retard imputable au constructeur pour chacun des deux premiers mois de retard à l'issue d'une période de grâce initiale de soixante (60) jours."

5. *Amount of the Penalty.* The penalty usually consists of the payment of a certain sum or a percentage of the price, per period of late performance:

- “Pour non-respect des délais garantis à l’article 10, A paiera à B 10.000 par semaine entière de retard pour chaque section.”
- “. . . A shall pay . . . liquidated damages at the rate of one per cent (1%) of the contractual price per week of delay . . .”

The penalty may increase if the delay persists:

“. . . un pour cent du prix des travaux d’infrastructure par mois de retard imputable au constructeur pour chacun des deux premiers mois de retard;

“deux pour cent du prix susvisé par mois supplémentaire de retard imputable au constructeur.”

6. *Basis of Calculation.* The basis of calculation for working out the percentage of the penalty often leads to interesting arrangements.

This basis may be strictly defined, limiting it to the part of the works that are behind schedule:

- “Au cas où la date d’achèvement des travaux ne serait pas respectée par suite d’une faute du fournisseur, le client pourra, pour autant qu’il prouve avoir subi un dommage, exiger pour chaque semaine de retard une indemnité de 0,50% avec un maximum de 5% de la valeur de la partie des travaux de montage non terminés dans les délais fixes.”
- “En cas de retard dans l’exécution des travaux, qu’il s’agisse de l’ensemble du marché ou d’une tranche pour laquelle un délai d’exécution partiel ou une date limite a été fixé, il est appliqué . . . une pénalité journalière de 1/3000 du montant de l’ensemble du marché ou de la tranche considérée.”

A consulting engineer will often seek to limit his liability according not to the value of the works, but to the amount of his fees:

“En cas de retard dans la mise en route de l’unité qui serait imputable à l’Ingénieur, sa responsabilité financière est fixée contractuellement à 1% du montant des honoraires tels qu’ils résultent de l’article XI, 1 et 3, par quinzaine de retard par rapport au délai prévu au premier alinéa de l’article IX.”⁹

⁹ Such limitations on liability are sometimes in breach of professional rules (see Rule 15.14 of the *Rules of the Association of Consulting Engineers*, as regards works carried out in the United Kingdom), or even of mandatory legislation regarding the liability of architects and building contractors (in particular in certain Arab countries).

In a contract for the construction of a factory in Algeria, the basis for calculating the penalties used the value of the equipment as a reference point:

“L’assiette des pénalités de retard dans la réalisation des opérations de montage ou de réalisation des performances contractuelles est calculée sur base de la valeur globale des matériels et pièces de rechange Cif-Port-Algérien.”

The following clause taken from another contract, concluded with Algeria, contains a novel variation:

“Au cas où, à la suite d’un retard de la part du constructeur dans la remise des spécifications et données nécessaires à la passation des commandes ou dans la préparation des appels d’offre dans le cadre des articles IV, V et VIII ci-dessus, M.O. serait contraint, afin de respecter le Planning Contractuel de Réalisation, de procéder à une importation de biens ou de services qui, en l’absence d’un tel retard, auraient pu être fournis dans les délais requis par une entreprise algérienne à des conditions aussi favorables, le constructeur paiera une pénalité égale à dix pour cent (10%) de la prestation ou de la fourniture considérée.”

Some very detailed contracts provide for specific differentiated bases of calculation according to the stages in the works at which the delays occurred:

“1° Pour un retard imputable au constructeur dans l’achèvement des travaux d’infrastructure . . . un pour cent du prix des travaux d’infrastructure par mois de retard . . .

“2° Pour tout retard . . . dans l’achèvement de l’édification du complexe industriel, les pénalités de retard seront calculées de la manière prévue au paragraphe 1° ci-dessus, étant entendu que l’assiette devant servir de base de calcul de ces pénalités sera constituée par le prix des travaux d’édification . . .

“3° Pour tout retard imputable au constructeur dans le démarrage des 3 unités de production . . . les pénalités de retard seront calculées de la manière prévue au paragraphe 1° ci-dessus, étant entendu que l’assiette devant servir de base de calcul sera constituée par la valeur du matériel de production non encore livré à laquelle s’ajoutera la valeur du matériel de production inutilisable par suite du retard de livraison d’une partie dudit matériel de production.

“4° Pour tout report non imputable à . . . de la signature du procès-verbal de la réception définitive . . . , les pénalités de retard seront calculées de la manière prévue au paragraphe 1° ci-dessus, étant entendu que l’assiette devant servir de base de calcul de ces pénalités sera constituée par le prix du matériel de production . . .”

Note that, in paragraph 3° of the preceding clause, the basis of calculation may be widened when the delay in performing a specific obligation has repercussions on the effectiveness of performance of other obligations.

That is also the purport of the following clauses, taken from conditions applying to public contracts concluded respectively with Portugal, Saudi Arabia and Egypt:

- “Si la livraison d’une partie seulement de la fourniture est en retard, les pénalités sont calculées sur la valeur de cette fraction; toutefois, elles sont déterminées d’après la valeur totale de la fourniture si ce retard rend inutilisable la fraction déjà livrée.”
- “The fine specified in the preceding Article shall be calculated on the final account for the entire operation if, in the opinion of the soliciting agency, the delayed part precludes full utilization of the work on the specified dates, or interferes with the use of any other utility, or has a direct adverse effect on the completed portion of the work.”
- “When time limits set by the contract are outpassed, the supplier and/or the contractor shall be subject to a penalty set as being 1% (one per cent) of the contractual value of the delayed part of each complete week of the delay, or of the total value of the contract if the delay affects the project of implementing the Metro. The Organization’s decision regarding the choice is final, and belongs solely to its discretionary authority.”

In the latter two instances, note the discretionary nature of the assessments to be made in each case.

7. *Ceilings.* Ceilings are commonly used in international contracts¹⁰ so that the penalty is limited to a certain maximum rate:

- “The total amount of the delay penalty will not exceed a maximum of four per cent (4%) of the price of the Contract.”
- “Contractor shall pay to the Owner as liquidated damages a sum equal to \$50,000 for every period of 10 days which shall elapse

¹⁰ Compare with Article 20.5 of the *Cahier de clauses administratives générales applicables aux marchés de travaux en France* (Decree of 21 January 1976): “le montant des pénalités . . . n’est pas plafonné.”

between the time mentioned above and the date of Ready for Start-Up of such Working Entity, provided however, that Contractor's liability under this Article 18.2 with respect to any Working Entity shall not exceed an amount equal to 5% of the price of such Working Entity."

If specific penalties have been laid down according to the different obligations, they may be cumulative:

"Les pénalités susvisées seront cumulatives, le cas échéant."

However, an overall maximum amount is often specified for the totality of the contractual penalties:

- "Le montant global des pénalités pour retard au montage et non conformité des performances est limité à Dix pour cent (10%) du montant global prévu dans le Contrat."
- "The total of penalties for delay will not exceed . . . % and the total of penalties for failure to reach the guaranteed performance will not exceed . . . % of the price of the equipments mentioned in Article 6. The total of all penalties shall not exceed . . . % of this price."

Whether we are looking at limiting the amount used as the basis of calculation for penalties, or imposing an individual or overall ceiling, these contractual practices highlight the function of the penalty clause in limiting liability.¹¹

8. *Amnesty*. Some contracts provide for the refund or reduction of penalties incurred during the initial phases of works if all or part of the delay is made up at a later date:

- "Les pénalités de retard versées à B conformément aux paragraphes 1^o et 2^o ci-dessus seront remboursées au constructeur dans la mesure où le démarrage de la production tel qu'il est prévu au Planning Contractuel de Réalisation aurait lieu effectivement à la fin des trente-neuvième (39^e), quarante et unième (41^e) et quarante-troisième (43^e) mois à compter de la date de prise d'effet en ce qui concerne respectivement l'unité-moteurs, l'unité-lampes et l'unité- "appareils ménagers."
- "Should the Constructor obtain Main Test Run Certificate by the 51st month, the same amount of penalties referred to above shall be refunded to the Constructor."

¹¹ Cf. *infra*, pp. 338–340 and 346.

- “If most of the Work is completed and can be operated continuously and should B and Contractor agree to operate the parts of the Plant which are Ready for Commissioning and if the production so achieved reaches 50% or 75% of the total production of fertilizers the penalty per week will be reduced respectively to 0.15% and 0.05% per full week.”

9. *Prior Formalities.* Is any penalty for delay due automatically or should any *notice* be given beforehand? In the absence of any express provision, reference should be made to solutions afforded by the law applicable to the contract, which vary.¹² Some of the clauses examined explicitly consider the point.

Here the requirement for notice is dispensed with:

- “The liquidated damages stated in Arts. 39 & 40 shall be applicable without notice, immediately after delay.”
- “En cas de dépassement des délais contractuels fixes dans le marché ou prorogés dans les conditions prévues à l'article 2.4., le Fournisseur est passible de pénalités, quelle que soit la cause du retard et sans qu'il soit besoin d'aucune notification préalable, la seule échéance du terme le constituant en demeure.”

And the opposite is found:

“The penalties, when applicable, will be paid by A upon request of the buyer submitted by registered mail.”¹³

10. *Proof of Loss or Damage.* One of the main advantages of the penalty clause is that it establishes, in advance, the amount of compensation payable, and it therefore dispenses the injured party from having to prove the loss or damage resulting from the other party's breach.

This is the main thrust of the following clause:

“The penalties for delay are incurred without the Organisation being obliged to summon the Contractor or give him any previous notice and without proof by the Organisation of special damage.”

¹² The rule “Dies non interpellat pro homine” (the debtor is not on notice solely as a result of effluxion of time) for example applies in French law (Article 1139 of the Civil Code) whereas it is excluded in German law (Section 286 II, 1) B.G.B.). The rule is not known in common law.

¹³ Another possible interpretation of the clause is that the requirement for a registered letter relates only to the payment of the penalty and that its becoming due does not depend on the giving of prior notice.

However, the Group encountered examples of clauses where the penalty for late performance only became payable where the injured party could show loss:

- “Au cas où la date d’achèvement des travaux ne serait pas respectée par suite d’une faute du fournisseur, le client pourra, pour autant qu’il prouve avoir subi un dommage, exiger pour chaque semaine de retard une indemnité de 0,50% avec un maximum de 5% de la valeur de la partie des travaux de montage non terminés dans les délais fixés.”
- “Il a été admis lors des discussions du 10/8/77 en nos usines que les pénalités ne sont applicables que si . . . doit supporter des dépenses supplémentaires consécutives à vos retards (pénalités exigées par le Client ou travaux à horaire spécial pour rattraper les retards).”

Such clauses, which favor the contracting party owing the obligation, are to be avoided by the party to whom the obligation is owed, since they deprive the penalty clause of a substantial part of its effectiveness.¹⁴

An intermediate situation can be illustrated by the following clause, where the burden of proof appears to be reversed, since the party owing the obligation has to prove the absence of damage to avoid application of the penalty clause:

“The penalties for delay are not applicable if the delay has caused no prejudice to the buyer.”¹⁵

11. *Arrangements for Payment.* The arrangements for payment of the penalty may be specified:

- “Liquidated damages shall comprise of the following and be paid in foreign currency.”
- “Any liquidated damages due from the Seller to the Purchaser under this Art. 10 shall be paid in US Dollars upon delivery of the object pursuant to Sections 7.6. and 7.7. hereof.”
- “The payment of these penalties will be effected by retention on the outstanding amount remaining due by . . . at the Last Ready for Commissioning Certificate and/or by transfer by the Contractor to . . .”

¹⁴ The problem raised by these clauses is not to be confused with the question whether payment of the penalty clause precludes the party to whom the obligation is owed from claiming additional damages (Cf. *infra*, pp. 346–349).

¹⁵ Compare with Article 7.3 of Contract No. 188 of the United Nations’ Economic Commission for Europe.

- “The Employer, without prejudice to the other collection methods, shall deduct the delay fines from sums due to Contractor.”

In the last two cases, the penalty is paid by offsetting; this system will be compared below with some forms of withdrawal payments (*clauses de dédit*).¹⁶

A more original clause is to be found in this contract concluded with a developing country:

“Toutefois, selon la nature et l’importance du retard d’une date de démarrage, le maître de l’ouvrage aura la faculté de demander en paiement de la pénalité prévue ci-dessus, la livraison gratuite par le constructeur des pièces qui devraient être fabriquées dans l’usine à la date de démarrage de la section de production concernée et qui ne le serait pas en raison d’un retard imputable au constructeur, étant entendu que la fourniture de ces pièces devra être effectuée (i) dans les quantités nécessaires pour assurer la production des produits dans les quantités minimales prévues à partir de chaque date de démarrage au Planning Contractuel de Réalisation et (ii) pour autant que la fabrication desdites pièces n’aura pas été assurée conformément aux normes de qualité et dans les quantités requises.”

This clause, whose application is left, to a considerable degree, to the discretion of the client (*selon la nature et l’importance du retard*) is obviously liable to put the builder in an awkward position if he does not manufacture the components in question himself. As far as the client is concerned, the attraction of this clause is, among other things, that it enables him to purchase the components in question without an import license, since the supply is free of charge.

12. *Combination With Other Remedies.* Does the payment of penalties on account of delay rule out any other remedy?

(i) Obviously, the obligation to perform still exists, as the following clauses show:

- “The payment or deduction of such Liquidated Damages shall not relieve the Contractor from his obligation to fulfil the Works and/or Services. . . .”
- “Les parties conviennent que la réalisation du complexe industriel et le démarrage des unités de production doivent être exécutées avec la plus grande diligence et dans le respect des impératifs visés

¹⁶ Cf. *infra*, pp. 336–337.

aux présentes. En conséquence, certaines pénalités de retard ont été prévues en vue d'assurer la sanction du non-respect de certains délais. Elles ne sauraient toutefois diminuer en rien les garanties stipulées aux présentes.”

(ii) However, the client will often reserve the right to rely on other remedies, such as the correlative suspension of payments:

“Delays in delivery, notwithstanding other penalties they may entail, have a suspensive effect on payments. Payments are resumed only after deliveries have been restored to their normal course.”

or the cancellation of the contract in whole or in part:

- “L’application des pénalités est indépendante des autres sanctions auxquelles le retard peut donner lieu, notamment la résiliation du marché.”
- “The Authority shall also have the right to require the Contractor either to complete the works and continue payment of the said sum or at once or at any time thereafter by simple written notice cancel the contract or take the execution thereof out of the hands of the Contractor.”
- “Si le calendrier d’exécution de la phase prototype figurant en annexe III n’est pas respecté, le titulaire encourt par jour de retard et sans mise en demeure préalable, des pénalités dont le montant est calculé par application de la formule ci-après . . . De plus, la commande annuelle du matériel de série pourra être diminuée par mois de retard d’un nombre de matériel égal au douzième de la livraison prévue. En cas de mois incomplet, cette diminution se fera pro rata temporis sur la base de . . . mois de 30 jours.”

(iii) Is the obligee entitled to claim additional damages over and above the amount of the penalty clause providing for compensation for delay? This is the aim sought by the following clauses:

- “Les pénalités de retard visées aux paragraphes 1 et 2 ci-dessus sont exclusives de tous dommages et intérêts auxquels le maître de l’ouvrage pourrait prétendre en raison d’un retard imputable au constructeur, à condition que la réception définitive intervienne de manière satisfaisante dans le délai contractuel.”¹⁷
- “Indépendamment des dispositions des Articles concernant les pénalités au cas où l’inexécution ou la mauvaise réalisation des obligations du Vendeur entraîneraient directement ou indirecte-

¹⁷ *A contrario*, therefore, additional damages may be claimed if the delay has not been made up at the time when final acceptance takes place.

ment soit un retard de mise en production, soit un arrêt de production de l'Unité, les Parties détermineront d'un commun accord le montant du préjudice subi par l'Acheteur et à payer par . . . A défaut d'un tel accord, les parties conviennent de s'en remettre à l'arbitrage tel que défini contractuellement, mais il est toutefois convenu entre les Parties que le montant total du préjudice ne pourra dépasser dix pour cent (10%) de la valeur de la chaîne ou installation considérée."

Sometimes provision is made for additional damages only in order to make good a specific type of loss:

"Si, par suite de la négligence ou de la mauvaise organisation du Fournisseur, le programme d'exécution défini à l'article 2.3. ne peut être respecté et si le retard par référence à ce programme d'une quelconque prestation à charge du Fournisseur engendre une modification des conditions (délais, coût . . .) dans lesquelles devaient se réaliser des prestations à charge d'autres fournisseurs, la responsabilité de toutes ces modifications induites incombera au Fournisseur. Le maître de l'Ouvrage sera en droit de revendiquer le paiement de dommages et intérêts sans préjudice à l'application des pénalités prévues en cas de non-respect des délais contractuels. Cette clause sera notamment d'application dans le cas de la fourniture tardive par le Fournisseur d'informations nécessaires à l'exécution d'autres fournitures que la sienne ou en cas de retard lors du montage engendrant des perturbations du planning de montage d'autres équipements."

The following clause, which provides for the non-application of indexation to the price of the performance that is delayed, also results in imposing an additional penalty on the contracting party in breach:

"During the period of such delay, price adjustments due to indexation as per sub-clause 8.5.1. shall not apply to the price of the delayed portion."

(iv) A novel additional remedy consists in deferring the starting point for the guarantee period:

"In such case, the guarantee period shall start upon payment of such liquidated damages."

This clause is intended to encourage rapid payment of the penalty. But does it not deprive the client of any guarantee in the meantime? It would be more appropriate to provide that the guarantee period should be extended rather than merely deferring its starting point.

(v) In contrast, some contracts, which are more favorable to the constructor, preclude any other sanction:

- “The penalties for delay in deliveries and for failure to reach the guaranteed performance are limitative and their payment which compensates the Buyer for the prejudice suffered excludes all other compensation for indirect or consequential damages.”
- “Au cas où la date d’achèvement des travaux ne serait pas respectée par suite d’une faute du fournisseur, le client pourra, pour autant qu’il prouve avoir subi un dommage, exiger pour chaque semaine de retard une indemnité de 0,50% avec un maximum de 5% de la valeur de la partie des travaux de montage non-terminée dans les délais fixés. Toutes autres prétentions seront exclues.”
- “The liquidated damages specified in each Section of this Art. 10 are independent of each other and cumulative and shall not limit or affect any rights of the Parties pursuant to any other provisions of this Contract, provided, however, that such liquidated damages shall be strictly limited to the extent specified in each Section and the Purchaser may not on account of the deficiencies specified in Art. 10 claim other than for such liquidated damages.”

Combining a penalty clause with other remedies gives rise to delicate legal problems depending on the applicable law.¹⁸

13. *Penalties and Incentives.* In some contracts, a penalty clause, penalizing delay in performance, takes over from a premium providing a reward for early performance. The following example shows how this combination creates a scheme to encourage the rapid execution of promised performance:

“A bonus/liquidated damages scheme related to Time of Performance has been agreed between Company and contractor as defined in Appendix 16 entitled ‘Delivery Incentive Scheme.’ The Incentive Scheme is established to motivate Contractor toward an early completion of the Plant, in consideration of the importance that such early completion has for Company.

...

“Bonus is the amount by which compensation of Contractor will be increased in accordance with the method of calculation specified herein.

¹⁸ Cf. *infra*, pp. 346–349.

“Penalty is the amount by which the compensation of Contractor will be decreased as liquidated damages in accordance with the method of calculations specified herein.

. . .

“INCENTIVE SCHEME

“The mechanical completion target date of fuel units is established as March 15, 1979.

“The mechanical completion target date of plant is established as June 15, 1979.

“The amount of bonus or Penalty attributable to Contractor shall be calculated as follows:

“If mechanical completion of fuel units occurs on or before the mechanical completion target date of fuel unit and mechanical completion of plant occurs on or before the mechanical completion target date of plant, Contractor will earn a Bonus of US Dollars \$750,000.

“If either mechanical completion of fuel units occurs after the mechanical completion target date of fuel unit or mechanical completion of plant occurs after the mechanical completion target date of plant, Contractor will pay a penalty of US Dollars \$750,000.

“For each calendar day that mechanical completion of fuel units comes earlier than mechanical completion target date of fuel unit, Contractor will earn a Bonus of US Dollars \$6,700 up to a maximum amount of US Dollars \$800,000.

“For each calendar day that mechanical completion of plant comes earlier than mechanical completion target date of plant, Contractor will earn a Bonus of US Dollars \$3,350 up to a maximum amount of US Dollars \$400,000.”¹⁹

Together with the bonus for early completion, the penalty clause becomes in this case a component of a novel incentive scheme. Later on we will discuss the relationship that should be established between penalty clauses and price adjustment clauses.²⁰

¹⁹ The clause in question has a curious, doubtless unintentional feature: on the operative date, there is an immediate switch from a bonus of \$750,000 to a penalty of \$750,000.

²⁰ Cf. *infra*, pp. 337–338.

14. *Failure to Comply With a Quicker Performance Date.* Another interesting clause examined by the Working Group penalizes very severely the delay of a builder who had obtained the order by offering rapid performance. The starting point of the penalties coincides with the time periods stipulated in the offer and the maximum amount of the fine is increased:

“En el caso que el Contratista hubiese consignado en su oferta una reducción del plazo indicado en 12.1 la multa indicada en 12.2.1. se aplicará a partir del vencimiento del plazo ofrecido. En este supuesto el valor límite del diez por ciento (10%) para la aplicación de multas por atraso mencionado en 12.2.1. se ampliará en un diez por ciento (10%) adicional por cada mes o fracción mayor de una semana de reducción del plazo ofrecido. Este último teniendo en cuenta que la reducción del plazo previsto es un elemento que incide en el cotejo de las ofertas.”

(b) *Contracts for Supply.* Some supply contracts provide, in the event of late delivery, for the imposition of similar penalties to those described in the above construction contracts. Thus, the clause below, relating to the sale of a ship, provides for a grace period, a progressive scale of penalties for late delivery and the option for the buyer to cancel the contract if the delay persists:

“Delayed delivery:

“(1) No adjustment shall be made and the purchase price shall remain unchanged if the Vessel is delivered within one (1) month after the Contract Delivery Date, otherwise provided for in this Contract.

“(2) For each and every day of late delivery, beginning with midnight of the day one (1) calendar month after Contract Delivery Date, the purchase price of the Vessel shall be reduced by deducting therefrom per diem of delay in delivery as follows:

- “a) Japanese Yen 800,000 per day for second month
- “b) Japanese Yen 1,200,000 per day for third month
- “c) Japanese Yen 1,600,000 per day for fourth month
- “d) Japanese Yen 2,000,000 per day for fifth month
- “e) Japanese Yen 2,400,000 per day for sixth month.

“The maximum for which adjustment shall be made shall be six (6) calendar months running from the delivery date as provided for in Article 7 hereof, otherwise set forth in this Contract.

“(3) However, if delay in delivery of the Vessel, for which the builder is responsible, continues for a period of over six (6) calendar months after Contract Delivery Date, the company may, at its option, cancel this Contract by serving upon the builder written notice of cancellation, or accept the vessel with adjustment as per Paragraph 1, sub-paragraph (2) of this article.”

Progressive penalties are also provided for by this clause taken from a supply contract for electrical equipment, but they take effect immediately and they are subject to a ceiling:

“Au cas de retard dans la livraison imputable au fournisseur, il lui sera appliqué les pénalités suivantes:

“Un pour mille (1/000) de la valeur CIF/ANNABA du matériel livré en retard par jour calendaire de retard pendant les quinze (15) premiers jours.

“Trois pour mille (3/000) de la valeur CIF/ANNABA du matériel livré en retard par jour calendaire de retard à partir du 16^e jour. Néanmoins, le montant de ces pénalités ne saurait en aucun cas dépasser 5% du montant global de la fourniture.”

The following clause, relating to the sale of tractor-vehicles, makes the payment of fines for late delivery preclude any other remedy:

“En caso de producirse demoras en la entrega de cualquiera de los Locotractores, el Vendedor pagará al Comprador en concepto de multa una suma equivalente al medio por ciento (0.50%) del valor, antes de cualquier ajuste de precio, por cada quince (15) días corridos o fracción mayor de siete (7) días corridos de atraso, hasta un límite del cinco por ciento (5%) del valor antes de cualquier ajuste de precio, de cada Locotractor demorado, con la salvedad que el Vendedor no pagará multas por demoras en el despacho o otros incumplimientos justificados o exentos de responsabilidad, según el Artículo N°11. Dichas multas a cargo del Vendedor constituirán la liquidación total de cualquier obligación del Vendedor hacia el Comprador por la respectiva demora.”

The following clause, taken from a contract between a Polish seller and a Swedish buyer, also stipulates exemption from other remedies. Note also the grace period, the buyer's release from the obligation to pay interest during the seller's delay and the buyer's option on the expiry of 180 days:

“If the object is delivered later than the date required . . . the Seller shall not be required to pay any liquidated damages for the first 30

days of such delay, but thereafter the Seller shall pay to Purchaser US \$7,000 as liquidated damages for each whole day exceeding such 30 days free of penalty.

“Furthermore, the Purchaser shall not pay interest on Letter of Credit amounts as per Art. 5, sect. 5.2. during such periods of delay for which the Seller is responsible. The Purchaser may not claim on account of any delay compensation over and above said liquidated damages or make any claim on account of any delay.

“If the delivery of the object shall be delayed for more than 180 days beyond the date required . . . for any reason, the Purchaser shall be entitled, at his option, to:

- “(a) reject the object, or,
- “(b) accept the object at the contract price . . . minus the liquidated damages, payable under this section 10.1 . . . , or
- “(c) accept the object at a mutually agreed price.”

(c) *Loan Contracts.* Appropriate compensation for the loss ensuing from delay in the re-payment of a loan of money normally consists in the fact that interest continues to accrue at the market rate. The sanction for delay ceases to be purely in the nature of an indemnity where provision is made for the interest normally due to be increased, as illustrated by the following example taken from a Eurodollar loan contract:

“4.5. *Interest Rate on amounts overdue*—If the Borrower fails to pay any sum on the date on which such sum becomes due and payable the Borrower shall (without prejudice to all other rights and remedies of the Agent and the Banks in respect of such failure) pay to the Agent for the account of the Banks to which such sum is due, interest on such sum from the date of such failure up to the date of actual payment (as well as before any judgment), calculated on a day to day basis for so long as such sum remains unpaid at a rate which is the aggregate of

“4.5.1. two and one half of one per cent per annum, and

“4.5.2. either

“4.5.2.1. in the case of a principal amount which becomes repayable during an Interest Period, until the expiration of that Interest Period, the arithmetic mean (rounded upwards to the nearest whole multiple of one sixteenth of one per cent, if such mean is not already such a multiple) of the respective rates quoted by the Reference Banks for the determination of the interest rate applicable to that Interest Period; or

“4.5.2.2. in any other case or if the Interest Period referred to in sub-paragraph 4.5.2.1. has expired, the arithmetic mean (rounded upwards to the nearest whole multiple of one sixteenth of one per cent, if such mean is not already such multiple) of the respective rates which the Reference Banks would from time to time have notified under sub-clause 4.4. if the overdue amount constituted an Advance made for successive periods (each of which shall constitute an Interest Period) of such respective duration as may be from time to time selected by the agent.”

2. *Breach of Performance or Warranty of Quality*

Performance guarantees are regularly provided for in various types of contracts, in particular contracts for the construction of plants, supplies of equipment and manufacturing licenses. Breach of such guarantees is often made subject to a system of penalties that have certain analogies with the penalties imposed for delays in performance. Similar clauses may also be operative in the event of breach of a warranty of quality given by the vendors.

(a) Hypothesis—Imputability. The hypothesis concerned is generally described by reference to the guarantee clauses themselves.

- “If the plant does not meet its Performance Guarantee (section 13 above . . .).”
- “Au cas où, après des essais de garantie répétés selon la clause numéro 11 . . . les garanties totales mentionnées dans les clauses n°12.2. et 12.3. ainsi que 12.4., ne peuvent être atteintes, . . .”

The problem of imputability does not arise where the obligation is an absolute one, as is the case, for example, with the guarantee for latent defects due from the vendor under French law (Article 1641 of the Civil Code). In contrast, a performance guarantee offered by a builder seems generally speaking—under the approach taken by French law—to come into the category of obligations to achieve a specific result, where the person under the duty to fulfill the obligation may still prove certain exonerating circumstances.

“In the event that . . . the equipment does not meet the minimum performance levels, except for reasons due to K or to force majeure or similar events beyond the control of A . . .”

(b) Differentiated Clauses. A clause providing for sanctions for short-comings in performance is sometimes broken down into specific provisions depending on the various components of the works or the various features of the breach:

“1.5.2.2. Liquidated damages (Performance)

“1.5.2.2.1. For non-fulfilment of the guaranteed capacity . . .

“1.5.2.2.2. For the Beneficiation Unit . . .

“1.5.2.2.3. For the Sulphuric Acid Unit . . .

“1.5.2.2.4. For the Phosphoric Acid Unit . . .

“1.5.2.2.5. For the Fertilizer Units . . .

“1.5.2.2.6. For the Fluorine Salts Units . . .

“2. Insufficient Speed . . .

“3. Excessive Fuel Consumption . . .

“4. Insufficient Deadweight Tonnage . . .”

(c) **Progressive Increase—Tolerance.** A scale of differences, in relation to the performances guaranteed, is often laid down whereby the penalties increase with the size of the difference. A tolerance may be provided for:

“En cas de non-obtention des qualités garanties, A paiera à B “les pénalités suivantes:

“Pour chaque 0,25% de P2 O5 en dessous de 31%, 3 millions FB.

“Pour chaque 0,25% de P2 O5 en dessous de 30%, 6 millions FB.

“Pour les premiers 5% de débit réduit: pas de pénalité.

“Pour les seconds 5% de débit réduit:?. Pour chaque 1% complet de débit réduit: 0,5% du prix du contrat.

“Pour les troisièmes 5% de débit réduit: 1%. Pour chaque 1% complet de débit réduit: 1% du prix du contrat.”

The following clause provides for a less elaborate system of proportionally reducing the price:

“Si l’alternateur ne peut fournir la puissance garantie, diminuée de la seule tolérance de mesure de cette puissance, le prix global sera réduit dans le rapport de la puissance réellement développée à la puissance garantie.”

In other contracts, the manufacturer enjoys a period of grace in order to attain the promised performance, before being punished either by penalty proportional to the additional duration due to its failure to fulfill his obligation or by a flat rate penalty:

- “A period of (4) months for commissioning is allowed from time of granting the Last Ready for Commissioning Certificate up to the

issuing of the Main Test Run Certificate. If the plant does not meet its Performance Guarantee (section 13 above) by the expiry of this period, the Contractor shall pay liquidated damages of 0.05% of the Contract Price for each day of the delay up to a maximum of 60 days.”

- “In the event that, four months after the contractual delivery date, the equipment is not ready for acceptance or does not meet the minimum performance levels, except for reasons due to K, or to force majeure or similar events beyond the control of A, K shall receive from A an additional sum of one hundred thousand French Francs (100,000) as liquidated damages.”

(d) Basis of Assessment. The basis for assessing the penalty may also vary as in the case of compensation for delay. Here is an example of a basis for assessment that varies according to the deficient element:

- “Above percentage will apply to the total Contract Price.”
- “For the NPK Unit and the Fluorine Salts Units, the same principle will apply but the percentage will apply to the price of each Unit.”

(e) Ceilings. Penalties for non-fulfilment of guaranteed performance are often subject to ceilings:

“Les pénalités payables par A au titre de l’article 11.1. ne pourront dépasser 6% du prix de vente.”

Furthermore, a global maximum limit is often laid down for the contractual penalties as a whole.

(f) Arrangements for Payment. The methods for the payment of compensation for non-fulfilment of guarantees are rarely specified. It is true, however, that they generally consist of a reduction in the price, which obviously facilitates recovery. Moreover, there is no question of proving the damage, since this is objectively established by the fact of insufficient performance.

(g) Combination With Other Remedies. Does payment of a performance penalty preclude any other remedy?

1. The clauses of this type considered by the group rarely raised this issue, unlike the clauses relating to delay discussed above. The only clause found was the following, where the penalty is expressly stipulated to release the other party from all other obligations:

“. . . the Contractor shall pay the liquidated damages according to the scale hereunder.

“After that payment, the Unit(s) shall be deemed to have completed the Test Run(s) and have met their performance guarantees.”

2. The scale of penalties, however, goes down generally only to a specific degree of default, beyond which other remedies may replace the penalties:

- “Pour un débit réduit et une non-obtention des quantités selon la clause n°12, de plus de 15%, l’acheteur est autorisé à:
 “soit demander une diminution correspondante de prix
 “soit demander la résiliation du contrat complète ou partielle.
 “Dans ce cas, un entretien aura lieu entre le vendeur et l’acheteur après le procès-verbal de prise en charge pour parvenir à un règlement à l’amiable.
 “Au cas où ce règlement ne pourrait être obtenu, le tribunal d’arbitrage décidera des droits et devoirs des deux partenaires du contrat.”
- “3.2. If the Equipment falls below 90 per cent efficiency the purchaser shall be entitled to return the Equipment to the supplier on the terms set out in sub-clause (4).
 “4. If the purchaser exercises his right to return the Equipment then:
 “(i) The supplier shall refund forthwith all the purchase money, including cost of transportation, all duties, levies and taxes and the cost of installation and commissioning; and
 “(ii) The supplier shall allow the purchaser the use of the Equipment free of charge for such a period (not exceeding twelve months) as the purchaser shall reasonably require to order and obtain delivery and installation of alternative equipment, and
 “(iii) The supplier shall remove the Equipment and make good the site at his own expense.”

(h) Penalties and Incentives. As with penalties for delay, compensation for insufficient performance or quality may be combined in an overall incentive system in which bonuses constitute a reward for performance or quality exceeding what was promised.

Here is an example in which a groundnut seller receives an increased price if he supplies products of superior quality or a decreased price if the products supplied are inferior:

“9. Quality: the groundnut kernels to be in good condition at the time of shipment and on arrival the basis shall be:

“(a) Purity: the Buyer to receive an allowance equal to the percentage of admixture.

“(b) 47% Oil Content to be determined in the pure kernels by total extraction method using ether as the solvent. Any excess to be paid for by Buyer and any reduction to be allowed for by the Seller at the rate of 1% of the contract price of each 1% oil. All fractions in proportion.

“(c) 3% Free Fatty Acid Content (expressed as Oleic Acid, Molecular Weight 282—and as a percentage of the extracted oil. Any reduction to be paid for by the Buyer at the rate of 1% of the contract price for each FFA.

“Any excess to be allowed for by the Seller at the rate of 1% of the contract price for each 1% FFA up to and including 7% FFA and the rate of 2% of the contract price for each 1% FFA over 7% FFA up to and including 10% FFA. All fractions in proportion. If the FFA content is over 10%, the Buyer shall receive an allowance to be agreed upon between the Buyer and Seller or by arbitration as stipulated in Clauses 21 and 22.”

With such a clause it is difficult to determine the demarcation line between a penalty clause and a price adjustment clause²¹.

3. *Failure to Supply*

The obligation of the vendor to supply the object of the contract rarely seems to be covered by penalty clauses.²²

However, here are two clauses of this type that were stipulated in order to cover eventualities in which failure to deliver could give rise to a particular loss or damage on the part of the purchaser.

(a) In a contract for the supply of steam, the clause provided for compensation proportionate to the duration of the failure to supply, but the vendor took care to limit his liability to the payment of that compensation:

“En cas d’inexécution d’une des clauses du présent contrat par l’Exploitant pouvant entraîner une diminution de l’énergie mise à disposition de X, ou en cas de demande de vapeur, conforme à l’article II (c’est à dire 3 heures avant) non-honorée, X sera fondé à réclamer à l’Exploitant une pénalisation égale à: $F(P2A, 5000)$ par heure complète d’insuffisance.

²¹ Cf. *infra*, pp. 337–338.

²² What is contemplated here is a case of irremediable failure to deliver; the case of a mere delay in delivery has been considered earlier.

“X pourra déduire ces pénalités des facturations que lui fera l’Exploitant au titre du présent contrat. Les pénalités prévues au présent article constituent les seuls dommages et intérêts susceptibles d’être réclamés par le Client tels que prévus au Code civil (article 1150 et suivants) par suite d’inexécution de ses obligations par le prestataire et ce, à l’exclusion de tout autre préjudice immatériel.”

The loss caused to the purchaser by an interruption of supplies of steam is liable to be disproportionately large in comparison to the supplier’s interest in the contract. The above clause limits his liability.

(b) The following clause illustrates the specific problem of establishing the damage ensuing from the failure of a sub-contractor. Such damage may also be considerable insofar as a default in relation even to a component or a secondary operation may compromise the whole of the operation. The following clause deals with the supply of gearboxes for cars by a sub-contractor:

- “Dans le cas où les chaînes de montage de véhicules destinés à recevoir les boîtes seraient arrêtées chez A ou chez l’un de ses sous-traitants en France, par manque de boîtes imputable contractuellement à B, B paierait à A une indemnité égale à la valeur de la boîte par véhicule qui ne pourrait pas être terminé de ce fait.
- “La quantité de véhicules à prendre en considération serait la quantité moyenne journalière de véhicules produits par A dans le mois précédent l’arrêt de chaîne. A doit informer B au moins deux semaines à l’avance de l’arrêt éventuel des chaînes de montage et B a le droit d’envoyer chez A un représentant pour constater les faits.”

This example is very characteristic of the special situation in which, because one contract is inserted into another, the failure to perform the former is bound to cause substantial consequential damage.

4. *Failure to Perform an Obligation to Purchase*

(a) Under some supply contracts, the purchaser undertakes to take a minimum quantity and this obligation may be the subject of particularly severe penalty clauses. Here is a first example:

“In case Buyer’s offtake during any calendar year will be lower than the quantity mentioned above minus 10%, then Buyer will pay to Seller over the difference in quantity between the thus fixed quantity and the quantity actually supplied a penalty of 50% over the

average selling price per metric ton paid in that particular calendar year.”

The following clause, which relates to a contract for the supply of gas, is even more draconian since the quantities not taken are invoiced (take or pay), which is tantamount to imposing a 100-percent compensation.

“Pour tous les débits constatés inférieurs au minimum convenu, X facturera à Z, à titre d’indemnité de mise à l’air, les quantités manquantes. Toutefois, aucune pénalité ne sera facturée si les quantités manquantes sont inférieures à 2% de la quantité d’hydrogène prévue d’être livrée dans le mois, cette quantité étant obtenue en multipliant les débits horaires convenus par le nombre d’heures convenu dans le mois.

Il est entendu que cette indemnité de mise à l’air ne sera versée que dans la mesure où les quantités manquantes seront dues au fait de Z, et dans la mesure où il n’y aura eu ni force majeure, ni entente préalable.”

The severity of the sanction is due to the fact that the gas not taken has to be evacuated (*mise à l’air*) and it is therefore lost to the vendor. On the other hand, such take or pay obligations in gas supply contracts are often also justified by the fact that the supplier is himself bound by long-term contracts containing strict obligations of purchasing minimal quantities.

(b) Counter-trade contracts also impose an obligation to purchase, that is to say the purchase of compensation products, to the extent of a specified percentage of the price of the main supply.²³ Typically, this obligation is coupled with a penalty clause:

“Au cas où B ne remplirait pas ou ne remplirait qu’en partie ses engagements d’achat pour des raisons dont il aurait à justifier, B verserait à A sans autres réclamations une pénalité de . . . % de la valeur de l’engagement non-rempli.

“En couverture des pénalités, B dépose à la mise en vigueur de l’accord une garantie bancaire auprès d’une banque de premier ordre. Cette garantie diminue en liaison avec le montant de la pénalité portant sur les sommes en compte.”

²³ See M. Fontaine, *Aspects juridiques des contrats de compensation*, *D.P.C.I.*, 1981, 7, pp. 179–223.

It will be noted that the penalty is covered by a bank guarantee, a stipulation habitually found in offset contracts.²⁴

5. *Failure of a Licensor to Discharge His Obligations With Regard to the Defense of Patents*

In a patent licensing agreement, the licensor undertakes to defend the patents against use by third parties. The sanction attached to this obligation consists in the provisional suspension of royalty payments:

“A shall take prompt enforcement action, against third party infringers whose infringement activity coincides with B’s efforts to sell Products manufactured under this Agreement. Failure on A’s part to take appropriate steps to enforce its rights under the patents in Appendix A within 90 days of notice by B of third party infringement activity noted above shall exempt B from payment of any further running royalty on Products that B continues to sell in the considered country.”

This suspension is not to be equated with the defense of withholding performance, as its effects are definitive: royalties unpaid during the licensor’s period of inactivity will never ever be payable. But is this a penalty clause? The sanction does not require the obligor to pay a sum of money, but he incurs the loss of a sum that would otherwise be payable to him.²⁵

6. *Failure to Comply With an Obligation to Refrain From Acting*

(a) Certain obligations to refrain from acting, which are imposed upon the licensee under a manufacturing licensing contract, stipulate penalties by the following clause:

“Sous réserve d’autres dommages que A aurait le droit de réclamer à B pour préjudices qui pourraient lui être causés, B s’engage à payer à A une pénalité de francs suisses 200 (deux cent francs suisses) par cheval effectif en cas de violation des articles II (interdiction prévue au deuxième alinéa), et article X du présent contrat et pour chaque moteur fabriqué, fourni ou vendu, directement ou indirectement, contrairement aux stipulations du présent contrat.

²⁴ *Id.* pp. 198–200.

This manner of proceeding is also mentioned in the proceedings of UNCITRAL: see Doc. A/CN9/WG.2/WP.33, February 12, 1981, No. 17.

²⁵ Cf. *infra*, pp. 340–341.

“En outre, A pourra, dans ce cas de violation de la part de B, résilier immédiatement de plein droit le présent contrat sans aucune indemnité ni dédommagement quelconque.”

Consequently, the clause does not preclude combining the penalty with additional damages; termination of the contract is also possible.

A similar provision may be found in a standard form contract relating to the sale of the right to use a tailor-made software product.

“Au cas où le client proposerait ou vendrait un programme, ou proposerait à la vente des services sur un programme ayant des performances comparables au progiciel qui fait l’objet du présent accord, . . . aurait le droit de faire examiner ce programme par un expert indépendant.

“Si cet expert constate que le programme cédé est identique en tout ou partie au progiciel objet du présent accord, ou en est manifestement une dérivation directe, le client devra verser à . . . 150% (cent cinquante pour cent) du prix reçu pour la fourniture du programme ou du service, mais au minimum 500,000 FF (cinq cent mille francs français) pour chaque proposition ou cession du progiciel, à moins que le client ne puisse apporter la preuve par écrit qu’il a acquis d’un tiers, notoirement possesseur d’un logiciel comparable, le droit d’utiliser et/ou de céder ledit programme.”

The severity of this clause is designed to make up for the weaknesses in the legal protection of intellectual property in the information technology sector. Vendors seek to protect themselves by contractual means and the deterrent effects of very heavy penalties. A further notable feature of this penalty clause is that it stipulates a minimum amount.

(b) The German Defense Ministry endeavors to suppress the granting of advantages to its representatives responsible for concluding public contracts. Since the applicable criminal provisions are liable to be without effect *vis-à-vis* foreign companies, contractual sanctions are arranged by ministerial circulars and inserted into contracts. Here is an example:

“Der Auftragnehmer oder seine Beauftragten dürfen Personen, die beim Auftraggeber mit Aufgaben auf dem Gebiet der Forschung, Entwicklung oder Beschaffung betreut sind, weder unmittelbar noch mittelbar Vorteile anbieten, versprechen oder gewähren. Dies gilt auch, wenn ein Vertrag über ein Vorhaben der vorbezeichneten Art nicht zustande kommt.

“Für jeden Fall der Zuwiderhandlung hat der Auftragnehmer dem Auftraggeber eine Vertragsstrafe in Höhe von 10% des im Angebot

genannten Preises zu zahlen. Gibt der Auftragnehmer innerhalb von 10 Jahren weitere Angebote ab, so sind bei der Berechnung der Vertragsstrafe auch die Preise dieser weiteren Angeboten mit einzurechnen. 12 VOL/B findet keine Anwendung. Der Auftraggeber kann bei Vorliegen besonderer Umstände die Vertragsstrafe nach Massgabe bestehender Vorschriften herabsetzen.”

It will be noted that the conduct to which the penalty applies is generally pre-contractual, and that the penalty applies even if the contract is not concluded (it is however binding if the party contravening the clause is bound by the conditions of the call for tenders to which it responded); this falls outside the normal run of penalty clauses. The seriousness of the penalty will also be noted, since it is applicable to all tenders made over the next ten years; consequently, a whole pattern of trading is affected.

B. General Considerations Concerning Practice

The analysis carried out by the Working Group is based principally on the sample collected by its members. This analysis has enabled a number of conclusions to be inferred with regard to practice in the matter of penalty clauses in international contracts. In what types of contracts do they appear in particular? To what types of obligation do they relate? What techniques are used to develop these clauses? But is the sample sufficiently representative as to allow the conclusions to reflect fully and faithfully what happens in practice?

It would be presumptuous to draw this conclusion. Penalty clauses are too diversified in their applications for the group to make any claim that it could have covered all their aspects having regard to the group's random composition and the manner in which its contributions were selected.

However, there has been other research into penalty clauses. The U.N. Commission on International Trade Law has taken an interest in penalty clauses, as we have already mentioned; uniform rules have been adopted. At the beginning of its work, UNCITRAL also gathered useful information about practice in this area.²⁶ Yet even though UNCITRAL obviously has better means of investigation at its disposal, no more does its sample appear to fully reflect the phenomenon as a whole as far as the Working Group has been able to tell. The brief reflections set out below compare the findings of these two research efforts with a view to pinpoint what has been established and what might be subject to further investigation.

²⁶ See Liquidated Damages and Penalty Clauses, Report of the Secretary General, Doc. A/CN.9/161, April 25, 1979 (hereinafter referred to as “the First UNCITRAL Report”) and Liquidated Damages and Penalty Clauses (II), Report of the Secretary General, Doc. A/CN.9/WG2/WP.33, 12 February 1981 (hereinafter referred to as “the Second UNCITRAL Report”).

1. *Types of Contracts*

As for the types of contracts in which penalty clauses were found, there is a marked difference between the Working Group's sample and the first sample used by UNCITRAL. The Working Group, doubtless owing to its particular make-up, principally concentrated on clauses taken from building contracts. In contrast, UNCITRAL's first sample was made up of 71 sales contracts, as against only five contracts "for the supply of equipment and service" and three other contracts.²⁷ UNCITRAL's secretariat realized that its sample was skewed in this way²⁸ and seems to have corrected it subsequently.²⁹

In any event, comparison of the two investigations shows that penalty clauses are frequently met, both in sales contracts and in construction contracts. But to judge by some of the examples cited,³⁰ they also appear to be present in other contracts (loan, transport, distribution, licensing, etc.), and it would be worth the effort of a more detailed analysis.

Furthermore, the first UNCITRAL sample apparently includes a substantial proportion of clauses taken from general conditions, whereas the Group worked almost exclusively on clauses incorporated in negotiated contracts. It seems that this difference was also attenuated by UNCITRAL's second sample.³¹ Without denying the quite special interest of clauses taken from general conditions (especially from UNCITRAL's perspective of drawing up a uniform law), negotiated clauses would be a better choice to reveal the wide variety of penalty clauses encountered in practice.

2. *Types of Obligations*

In our view,³² what is more enlightening is the analysis based on the types of obligations which may suitably be the subject of penalty clauses. We have set out here the very interesting table drawn up by UNCITRAL's secretariat on the basis of its first sample:

²⁷ First UNCITRAL Report, p. 11, No. 32 (pagination is given for the English version of the two reports).

²⁸ *Id.*, p. 13, note (11).

²⁹ Second UNCITRAL Report, p. 5, note (7). However, no more figures are given against the list.

³⁰ Cf. *supra*, pp. 318–319 and 326–328.

³¹ Second UNCITRAL Report, p. 5, No. 8.

³² Cf. *supra* pp. 301–302.

"Kinds of breach for which liquidated damages or penalties were payable, the number of liquidated damages or penalties clauses for each type of breach:

<i>Delay in delivery goods by seller:</i>	24
<i>Delay in payment by buyer:</i>	24
<i>Delay in shipment by seller:</i>	11
<i>Diminution of price consequent upon quality defects in goods:</i>	10
<i>Delay by buyer in taking delivery:</i>	5
<i>Failure to meet guaranteed standards:</i>	4
<i>Non-delivery of goods:</i>	4
<i>Violation by buyer of prohibition of export out of the country of destination:</i>	3
<i>Default in general:</i>	3
<i>Delay in delivery of technical documentation:</i>	2
<i>Non-payment of the price:</i>	2
<i>Payment by borrower in advance of the stipulated date of repayment:</i>	1
<i>Default in tender of documents:</i>	1
<i>Default in shipment by seller:</i>	1
<i>Delay by buyer in taking up documents presented by seller:</i>	1
<i>Payment by buyer not in accordance with instructions:</i>	1" ³³

This list confirms one of the Working Group's findings, namely the particular frequency of penalty clauses for delay in performance. UNCITRAL observed this in connection with sales (obligations of the vendor)³⁴ as the Group mainly found with regard to construction contracts (obligations of the builder). In contrast, whereas UNCITRAL found numerous clauses containing a penalty for delay in the payment of the price by the purchaser, surprisingly, the Group did not find any clauses covering delay in the payment of the price by the client. Conversely, the Group found numerous penalty clauses relating to performance guarantees,³⁵ while UNCITRAL concluded that such clauses were infrequent.³⁶ Complementary investigations of these two practical aspects would be useful.

The relative rarity of clauses imposing penalties for failure by the vendor to deliver as found by the group³⁷ is borne out by UNCITRAL's list.

In view of its interest, we will include a passage from the Second UNCITRAL Report, which sets out to establish a link between the stipulation of a penalty clause and the characteristics of the obligation to which it relates:

³³ First UNCITRAL Report, pp. 11–12, No. 32.

³⁴ *Id.*, p. 11, No. 32.

³⁵ Cf. *infra*, pp. 319–323.

³⁶ Second UNCITRAL Report, p. 14, No. 33.

³⁷ Cf. *supra*, pp. 323–324.

“An analysis of these clauses indicated that their use was associated, not with the contract being of a certain type, but with the probable presence of some of the following features:

“(i) Breach of the main obligation was relatively easy to prove (e.g. Failure to deliver on time, failure to meet a technical specification);

“(ii) The existence of some basis at the time of conclusion of the contract for estimating the loss likely to be caused from a breach. In regard to some types of contracts, norms appeared to have developed in the trade defining the limits of the agreed sums which parties might stipulate;³⁸

“(iii) Proof of actual loss might be costly or difficult;

“(iv) Breach of the main obligation is not of so serious a character as to justify, at least initially, the ending of the relationship between the parties;

“(v) A need to limit the liability exposure of the party liable for breach of the main obligation;

“(vi) Circumstances which make it important to a party that he receive performance and not damages for breach.”³⁹

3. Absence of Penalty Clause

The absence of a penalty clause in certain contracts or with regard to some obligations may provide *a contrario* proof of the foregoing analysis. UNCITRAL has published a number of statistics,⁴⁰ which tended to show, on the basis of the first sample, that penalty clauses were absent from more than half the contracts. There did not seem to be any correlation between trade in a given product and recourse to such clauses. UNCITRAL further raised the question whether the applicable law might not play some role, since the draftsman of a contract subject to common law, for example, perhaps fear that any penalty clause would be null and void.⁴¹

³⁸ “Thus, in relation to international construction contracts it has been stated: ‘the rate of deduction for late performance varies with the size, complexity and importance of the project. As a general guide, the rate is frequently between 0.0001–0.001 per cent of the contract price per day. An upper limit is not generally specified, but if one is desired 5–10% would be reasonable.’ *Guidelines for Contracting for Industrial Profits in Developing Countries* (UNIDO publication ID149 and Corr. 1), page 22.”

³⁹ Second UNCITRAL Report, pp. 24–25, No. 52.

⁴⁰ First UNCITRAL Report, p. 11, No. 31, and p. 13, No. 33.

⁴¹ *Id.*, p. 14, No. 35. Conversely, contracts subject to the law of a country with a planned economy frequently contained penalty clauses due to the particular importance of the performance of contracts with a view to the achievement of the Plan.

In its second study, UNCITRAL's secretariat related the possible absence of a penalty clause to the aforementioned criteria that, actually, favor the insertion of such a clause. Ease or difficulty in proving breach of the relevant obligation would appear to play an important role. Thus, a penalty clause seems inappropriate with regard to the obligations of a researcher under a research contract; such obligations can only be defined in a flexible and evolutive way and their breach cannot be determined in the same objective way as a delay in delivery.⁴²

The Working Group took note of these considerations and largely agree with them. Similar observations may be made with regard to certain aspects of industrial cooperation contracts. To use French legal terminology (now also found in the Unidroit Principles, Articles 5.4 and 5.5), it might be said that penalty clauses are more appropriate with respect to "obligations to achieve a specific result" than concerning "obligations of best efforts."⁴³

The absence of a penalty clause may have two more specific reasons. Sometimes the psychology of negotiation acts as a disincentive to proposing the insertion of such a clause for fear of damaging the good climate by raising the possibility, already at this stage that the contract performance might be less than perfect. Sometimes too, despite the differences between a penalty clause and withdrawal payments (*clauses de dédit*),⁴⁴ there is unwillingness to inform the other contracting party of the price it would have to pay in order to purchase its freedom.⁴⁵

4. Drafting Technique

The UNCITRAL secretariat also made a number of interesting observations about drafting techniques used in penalty clauses, resulting in particular in the following table:

"Methods adopted to determine the amount of the liquidated damages or penalty and their frequency:

"By reference to a percentage of the price of the goods and to another factor, e.g. amount of delay or extent of deviation from agreed standards: 29

⁴² Second UNCITRAL Report, p. 25, No. 53.

⁴³ On this distinction, cf. *supra*, Chapter 4, pp. 218–222.

⁴⁴ Cf. *supra*, pp. 236–237.

⁴⁵ See the observation to this effect in M. Fontaine, *Aspects juridiques des contrats de compensation*, D.P.C.I., 1981, 198.

“By reference to a percentage of the payment due and to another factor, e.g. amount of delay in payment: 18

“By reference to a percentage of the value of goods delayed in delivery and to the extent of delay: 15

“Amount of penalty undetermined in contract form, and to be fixed by parties: 9

“By reference to the rate of interest usual for delayed payment in a particular country and the extent of delay: 8

“By reference to the weight or quantity of goods and to the extent of delay: 4

“By reference to a percentage of the cost of defective goods and the extent of deviation from agreed standards: 4

“By reference to a percentage of the difference between the market price and the contract price: 2

“By reference to a sum which, if not paid, would enable the defaulter to make a profit out of the default: 1.”⁴⁶

The First UNCITRAL Report also emphasizes the adverse effect, as to the effectiveness of the penalty, of the occasional stipulation that makes payment of the penalty dependent upon proof of actual loss or damages.⁴⁷

The Second UNCITRAL Report provides a certain amount of additional information about the manner of payment of the penalty (direct payment, relinquishment of a sum due, recourse to a bank guarantee)⁴⁸ and about the contractual treatment of the problem of the imputability of the breach to which the sanction relates.⁴⁹

These findings of UNCITRAL are largely borne out by the research whose results are set forth in the first part of this chapter. However, our analysis brought to light other frequent or, at the very least, characteristic features of techniques for drafting penalty clauses in international con-

⁴⁶ First UNCITRAL Report, pp. 12–13, No. 32; see also p. 14, No. 38.

⁴⁷ *Id.*, p. 14, No. 39. Cf. above pp. 309–310.

⁴⁸ Second UNCITRAL report, pp. 8–9, Nos. 17–18.

⁴⁹ *Id.*, pp. 10–12, Nos. 21–27. The Second UNCITRAL Report also considers the problems of combining a penalty, on the one hand, with performance or additional damages, on the other. (Cf. *infra*, pp. 346–349).

tracts. Reference is made, in particular, to the details and illustrations provided with regard to granting grace periods or tolerance margins, the fixing of maximum amounts and overall maximum amounts, the widening of the basis of assessment in the event of indirect damage, the possible remission or reduction of penalties, the combination of penalties and bonuses in an incentive system, etc. No doubt, these features were not worth raising in the context of UNCITRAL's work, directed as it was towards the preparation of a uniform law. But they are worthy, it seems to us, of the attention of practitioners called upon to negotiate the drafting of sophisticated penalty clauses.

The *I.C.C. Guide on Penalty and Liquidated Damages Clauses* also has drafting advice that coincides with the analyses and recommendations of this chapter. The following ICC recommendations deserve special mention:

“Any clause should clearly indicate whether it intends only to assess actual damages for breach or whether it intends to encourage performance by providing a private penalty as a deterrent against breach where the penalty provides for additional payments to be made on top of damages;

“Any clause should clearly indicate whether it is exclusive or optional (i.e., whether or not it may be combined with other remedies, particularly with termination for breach and payment of damages);

“Any clause should clearly indicate whether its lump-sum character implies that its drafters were envisaging that the lump-sum was a provisional or a final assessment of future damages.”⁵⁰

III. LEGAL ANALYSIS

Some aspects of the drafting of penalty clauses may safely be left to freedom of contract, irrespective of the applicable law; the stipulation of a grace period is an example. An informed negotiator may merely choose from among the technical methods available, while obviously looking carefully at the quality of the drafting.

But other questions are more delicate because they call into question principles of the law relating to liability, and there the applicable law may lay down binding rules. The relationship between the compensation stipulated and the actual loss or damage is rarely a matter of indifference; a discrepancy may result in the penalty being reduced or declared invalid. Generally speaking, national law has something to say about the possible combination of a penalty and specific performance or additional damages. These problems

⁵⁰ *I.C.C. Guide on Penalty and Liquidated Damages Clauses*, pp. 18 and 25–26.

must be mentioned. In the first place, however, their field of application needs to be defined; that is what the expression “penalty clause” mean.⁵¹ There is a series of similar situations, marginal or doubtful, and it is important to lay down some guidelines: the rules applicable to penalty clauses, in principle,⁵² do not apply to stipulations of a different kind.⁵³

A. Penalty Clauses and Similar Clauses⁵⁴

1. *Penalty Clauses and Clauses “for Winding Up the Contract”*

Clause 9 of a hire purchase contract grants the hirer the power to terminate the arrangement before the agreed term; clause 10 allows the owner to bring the contract to a premature end in the event that the hirer is in breach of his obligations or goes bankrupt.

Clause 11 provides as follows:

“Upon termination of this agreement pursuant to clause 9 or 10 hereof . . . the hirer . . . shall pay to the owner the hire purchase price of the goods less the aggregate of

“(1) the sums previously paid under the agreement;

“(2) the sums due under the agreement (including any sums recoverable from the hirer under 5 hereof) up to the date of termination;

“(3) the net proceeds of sale of the goods if repossessed and sold or if not, their value as determined by a dealer appointed by the owner and

“(4) a discount for the acceleration of payment computed according to the direct ratio or ‘rule of 78’ method.

“For the purposes of this clause ‘the net proceeds of sale’ shall mean the proceeds of sale after deducting the cost and expenses of repossession storage insurance and sale.

⁵¹ At the beginning of this review, a penalty clause was defined as “a clause stipulating payment of a sum of money in the event of non-performance of a contractual obligation” (Cf. *supra*, p. 300).

⁵² Comp. A. Pinto-Monteiro, *op. cit.*, p. 746, who claims that liquidated damages clauses may also be modified on grounds of equity.

⁵³ Other problems could be examined, such as the fate of penalty clauses when the contract is terminated (cf. Liège, Jan. 15, 2001, *Journ. Trib.*, 2001, p. 311). This is related to penalty clauses possibly belonging to obligations “surviving termination” (cf. *infra*, Chapter 13).

⁵⁴ Cf. D. Mazeaud, *La notion de clause pénale*, Paris, L.G.D.J., 1992.

“If the net proceeds of sale of the goods repossessed and the amount paid by the hirer pursuant to this agreement exceed in the aggregate the amount of the hire purchase price (with interest on overdue instalments and other sums payable by the hirer under clause 5 hereof) the excess shall be repaid to the hirer.”

Such a clause is not a penalty clause. In the first place, it does not necessarily lay down a sanction for a contractual breach: the clause applies, in particular, when the hirer terminates the agreement or when the agreement is terminated as a result of the hirer's bankruptcy. Secondly, the clause does stipulate down compensation in the form of a lump sum, but simply sets out the basis on which the re-payment will be calculated.

2. *Penalty Clauses and Withdrawal Payments (Clauses de Dédit)*

In some contracts, one party reserves the right to release itself from its commitments in return for a sum of money. Accordingly, that party has a genuine option. The other party to the contract cannot call this into question, for example, by purporting to enforce the undertaking in question. Such withdrawal payments (*indemnités de dédit*) are not remedies for contractual breaches; they reflect the exercise of an agreed choice.⁵⁵

Such an indemnity is clearly distinct from a penalty clause, at least in theory. In practice, it may be difficult to draw the distinction. Some authorities have rightly pointed out that the aims pursued by such clauses are very similar to those of penalty clauses.⁵⁶

The following example of a withdrawal payment is taken from the Second UNCITRAL Report:

“It is further agreed that this arrangement and all rights and obligations hereunder may be terminated by (Seller) at any time for any reason which it, in its sole discretion, deems desirable, provided, however, that, except in the case of default in performance by Distributor, Seller gives at least 30 days notice of its intention to do so to Distributor. Commission earned during the notice period, if and when notice is required, shall be liquidated damages resulting from said termination.”⁵⁷

⁵⁵ Comp. D. Françon, *op. cit.*, p. 481.

⁵⁶ D. Françon, *id.*; First UNCITRAL Report, p. 5, No. 9.

Mention may also be made of the doctrine of “efficient breach,” under which a contract obliges a party *either* to effect performance *or* to pay damages if performance proves less profitable. See, for instance, Ch. J. Goetz & R.E. Scott, Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach, 77 *Col. Law Rev.*, 1977, pp. 554–577; B. Rudden, La théorie de la violation efficace, *Rev. Int. Dr. Comp.*, 1986, pp. 1015–1041.

⁵⁷ Second UNCITRAL Report, p. 10 No. 19.

Despite the use of the expression “liquidated damages,” the commission payable does not constitute a penalty for breach, but the price paid for exercising the option of termination.

Another clause, (also called *dédit*, the terminology varies), more closely resembles a penalty clause insofar as it lays down a sanction for a genuine breach of contract. Under such a clause, sums already paid by the debtor, by way of account or security, are retained by the creditor in the event of non-performance.⁵⁸ The analogy with penalty clauses is clear if the relinquishment of the sums in question constitutes flat rate compensation and not an indemnity to be taken into account when assessing damages the amount of which remains to be established. In the case of a lump-sum payment, it is worth mentioning the peculiar feature that the payment of the “penalty” precedes the breach for which it is intended to be a sanction.⁵⁹

This situation in which the party in breach relinquishes a sum, which it has already paid, should not be confused with the one in which payment under the penalty clause is carried out by offsetting sums owed by the creditor.⁶⁰

3. *Penalty Clauses and Price Adjustment Clauses*

Clauses providing for a penalty for a delay in carrying out an obligation or for inadequate performance as compared with the guarantees given, often provide for a scale of penalties, calculated as progressive percentages of the amount of the price.⁶¹

But are penalties invariably involved? Is it not conceivable to have a system under which the price varies in accordance with the delivery time and the quality of performance obtained? This analysis can also cover situations in which the contract provides not only for “penalties” but also for “bonuses” in the event of early performance.⁶²

It is quite difficult to establish a distinguishing criterion. In theory, in the one case the clause penalizes a breach of contract, whereas, in the other, the supplier has a genuine option to deliver a variable quality at his discretion (obviously within certain limits) and this is reflected in the price.

In international contracts, the parties’ intention is undoubtedly betrayed by the fact that, in general, such clauses expressly refer to the con-

⁵⁸ P. Ellington, *op. cit.*, pp. 507–514; First UNCITRAL Report, p. 5, No. 11.

⁵⁹ Such clauses will be examined further below at pp. 340–341.

⁶⁰ Cf. *supra* pp. 310–311.

⁶¹ Cf. *supra* pp. 304–305 and 319–321.

⁶² Cf. *supra* pp. 314–315 and 322–323.

cept of “indemnity” or “penalty.” If this were to be combined with other sanctions, this interpretation would be reinforced.⁶³ Additional evidence might also be found in the possible deterrent nature of the increases.

4. *Penalty Clauses and Judicial Penalties (Astreintes)*

The distinction between penalty clauses and judicial penalties (*astreintes*) has brought about a split between some members of the Working Group. The question arises where the penalty clause provides for the payment of progressive indemnities for delay.

As far as some of the French and the Belgian members are concerned, there is no question of confusing such a clause with an *astreinte*. Admittedly, an *astreinte* also constitutes a progressive penalty for delay. But it is a penalty imposed by the court as a sanction for delay in carrying out the judgment, and it is necessarily in the nature of a deterrent. *Astreintes* do not constitute agreed upon sanctions.⁶⁴

However, other French members of the group consider that when the contractual stipulation of progressive compensation for delay is in the nature of a threat, this constitutes “contractual *astreinte*” and not a penalty clause.⁶⁵ The point of this analysis is that if the clause is interpreted in this manner, it would fall outside the courts’ power of revision as provided for in Article 1152, paragraph 2, of the French Civil Code.

Without doubt, the origin of this controversy is to be found in the use of the term “*astreinte*” in some contracts drawn up in French. But the denomination used by the parties is not decisive in law. It would certainly not be sufficient to name a penalty clause an “*astreinte*,” in order to escape the application of binding legal rules.

5. *Penalty Clauses and Clauses Limiting Liability*

The discussions, about which penalty clauses have given rise, in recent years in the various countries have brought to light two of the main functions of such clauses: the indemnifying function and the deterrent function. Sometimes it is a question of providing in advance for a flat-rate sum that will adequately make good the damage resulting from any failure to perform; sometimes the clause threatens the debtor with a veritable penalty, unrelated to the damage, that can provide it with an incentive to

⁶³ The characteristics of the clause quoted at *supra*, pp. 314–315 above (referred to in note 19) also suggest that it is, in fact, a penalty.

⁶⁴ For a more detailed comparison, see I. Moreau-Margrève, *L’astreinte*, *Ann. Fac. Dr. Liège*, 1982, pp. 47–51.

⁶⁵ See in particular D. Françon, *op. cit.*, p. 481.

perform or punish it in the event of a default. Notoriously, in some countries, this alternative will make the clause subject to reduction, if not a declaration of nullity.⁶⁶

Examination of practice brings to light a third—very frequent—function of penalty clauses. When they are inspired by the obligor himself, they are a means for him to limit his liability. Examples have been provided in which the compensation was limited to a given ceiling (often capped by a global ceiling) and clauses where the limitation related to the basis for assessing the penalty (cf. the liability of the consulting engineer, which was limited, not to a percentage of the value of the works, but to the amount of its fees).⁶⁷ UNCITRAL has already stressed the frequent role played by penalty clauses in this area.⁶⁸

Sometimes this function is very explicit. In a contract considered by the group, it was set out in a specific paragraph of the “Contractor’s Limit of Liability” clause, which was separate from the “Liquidated Damages” clause itself. The paragraph in question was worded as follows:

“Contractor’s only liability with respect to time of performance shall be the payment of the liquidated damages specified in Article 11, limited to the maximum amount of U.S. Dollars 750,000 (seven hundred and fifty thousand).”

How, in these circumstances, can a penalty clause be distinguished from a clause limiting liability?⁶⁹

In principle, the difference is that the penalty clause establishes a flat-rate amount, whereas a clause limiting liability fixes a ceiling below which the amount of compensation generally still has to be determined.⁷⁰ Here is an example of such a clause:

“Au cas où, pour des motifs imputables au fournisseur, l’exécution des prestations contractuelles deviendrait impossible, dans sa totalité ou partiellement, le client serait autorisé à se désister du contrat ou à demander des dommages-intérêts. Le taux des dommages-intérêts sera limité à 10% du prix convenu pour les prestations non-exécutées par suite de l’impossibilité survenue dans ces conditions.”

⁶⁶ This question will be taken up at *infra*, pp. 342–346.

⁶⁷ Cf. *supra*, p. 365.

⁶⁸ Second UNCITRAL Report, p. 9, No. 19.

⁶⁹ On such clauses, cf. *infra*, Chapter 7, and especially p. 355.

⁷⁰ See to this effect, the First UNCITRAL Report, pp. 5–6, No. 12.

But certain shades of difference have to be taken into account. The penalty clause may lay down the basis for calculating a lump sum, which may vary according to the circumstances (for example, an amount per day of delay) and, if so, may be coupled with a ceiling. Nevertheless, such a stipulation continues to be in the nature of a penalty clause, since the determination of the compensation is still based on a pre-determined, flat-rate foundation. On the other hand, if the clause limiting liability is generally limited to laying down a ceiling, there is nothing to prevent the two techniques from being combined and a limited indemnity being determined on a flat-rate basis. In this case, there will be both a penalty clause and a clause limiting liability; this is true of the first example referred to.

Consequently, numerous penalty clauses can be clearly distinguished from clauses limiting liability and *vice versa*, but there are stipulations that have a dual nature. They may be identified on account of their having, at the same time, a flat-rate and a restrictive nature.

When a penalty clause also limits liability, its validity must be assessed in a specific manner. We shall be returning to this subject.⁷¹

6. *Penalty Clauses and Penalties Not Consisting of an Obligation to Pay a Sum of Money*

A penalty clause stipulates, in principle, payment of a sum of money by the party in default. At least, this was the definition that we adopted on a provisional basis at the beginning of this study.⁷² But is it essential that it should have this characteristic in order to continue to be a penalty clause?

Two other types of sanctions appeared in the Group's sample. In one case, failure on the part of a licensor to pursue counterfeiters resulted in the suspension of the payment of royalties.⁷³ The other case was one in which a manufacturer causing the delay had to deliver components in kind that the factory should have manufactured.⁷⁴ Mention should also be made of the situation with regard to liquidated damages clauses in which the sanction consisted in the debtor relinquishing sums which he had paid in advance.⁷⁵

⁷¹ Cf. *infra*, p. 346.

⁷² Cf. *supra*, p. 300.

⁷³ Cf. *supra*, p. 326.

⁷⁴ Cf. *supra*, p. 311.

⁷⁵ Cf. *supra*, pp. 336–337.

Following UNCITRAL (First Report, p. 5, No. 10), the group also considered “accelerated payment” clauses, under which the debtor is obliged to repay the balance at an

Can this range of sanctions still be described as penalty clauses, possibly subject to binding legal rules?

The solutions adopted nationally differ. The Swiss Code of Obligations does not specify the nature of the penalty, but rules that “provisions relating to the penalty clause shall be applicable to an agreement by which part payments made are to be acquired by the creditor in the event of termination” (Article 162). Other legislation is broader. Under German law, a penalty consists in principle of the payment of a sum of money (BGB, Section 339), but the rules apply, *mutatis mutandis*, when “another performance” was promised (Section 342).⁷⁶ Under the French Civil Code, “a penalty clause is a clause whereby a party . . . undertakes to do something in the event of non-performance” (Article 1226). Belgian law has modified this provision, which now refers to payment of a flat-rate indemnity. The Italian Civil Code refers to the debtor’s undertaking to carry out “a certain performance” (Article 1382). It would appear that a penalty does not necessarily consist of a sum of money in either English⁷⁷ or Spanish⁷⁸ law.

The applicable law is therefore not a matter of indifference. It may affect penalty clauses, not only clauses providing for the payment of a sum of money, but also, depending on the case, clauses providing for the relinquishment of sums of money or even for any other performance. Draftsmen of such clauses will be conscious of this when the law of the contract submits penalty clauses to binding rules.

International initiatives designed to regulate penalty clauses have resulted in different positions being adopted. The recommendation of the Council of Europe covers only the payment of a sum of money (Article 1). The broader Benelux Convention refers to “payment of a sum of money or any other performance” (Article 1). UNCITRAL restricts the scope of its uniform rules to stipulations providing for the payment or the relinquishment of a sum of money (Article 1). Consequently one form of liquidated damages, but not non-pecuniary performance, is covered.⁷⁹ The Unidroit Principles only refer to payment of a “specified” sum (Article 7.4.13), as do the Principles of European Contract Law (Article 9:509).

earlier date in the event of default. In themselves, the sums reimbursed are certainly not penalties, since they constitute the very object of the obligation. But the sanction lies in the disadvantage for the debtor of losing the benefit of the term; this disadvantage may not be equated with a penalty clause since it is not of a flat-rate nature.

⁷⁶ Cf. M. Strauch, *op. cit.*, p. 499.

⁷⁷ P. Ellington, *op. cit.*, p. 507.

⁷⁸ B. Cremades, *op. cit.*, p. 463.

⁷⁹ Second UNCITRAL Report, p. 7, No. 13.

B. Whether the Clause May Be Declared Null and Void or Revised

(a) The most critical legal problem with which the draftsman of a penalty clause in an international contract has to grapple is the question whether a clause providing for an excessively severe sanction may be annulled or at least cut back.

1. Most national legal systems empower the courts to review excessive penalty clauses to a greater or lesser degree. In some cases, clauses not designed to be purely in the nature of an indemnity are annulled (England, Scotland,⁸⁰ Ireland,⁸¹ United States); in others, the courts are entitled to mitigate a penalty deemed disproportionate to the extent of the loss or damage (Germany, France, Belgium,⁸² Luxembourg,⁸³ Switzerland, Italy, the Netherlands, Portugal, Algeria, etc.).⁸⁴ For more detail, the reader is referred to the monographs on national law drawn up by members of the Working Group as cited above.⁸⁵ In principle, such provisions are binding and likely to affect

⁸⁰ H. Schelhaas, *op. cit.*, pp. 1397–1399.

⁸¹ K. Hoy, Penalties and liquidated damages clauses in England and Ireland, in *Structuring international contracts*, D. Campbell (ed.), The Hague, Kluwer Law International, 1996, pp. 243–251.

⁸² Articles 1226 and 1231 of the Belgian Civil Code, as modified by the Law of November 23, 1998. This reform prohibits penalty clauses of a deterrent nature and empowers the judge to reduce amounts that are excessive in relation to the foreseeable damage. With this modification, Belgium occupies an intermediate position between common law countries (nullity of deterrent clauses, validity of clauses of liquidated damages) and most civil law countries (validity of clauses of both kinds, judicial review of excessive amounts); cf. H. Schelhaas, *op. cit.*, pp. 1412–1413.

⁸³ Law of March 15, 1987 cited by D. Philippe, Autonomie et contrôle des clauses contractuelles dans les relations entre professionnels, in *Le droit des affaires en évolution, L'entreprise et son client: un partenariat constructif*, Association belge des Juristes d'Entreprise, Brussels, Bruylant, 1997, p. 213.

⁸⁴ Note also that, under French law, the courts may increase a penalty deemed to be derisive (Civil Code, Article 1152, paragraph 2); see D. Françon, *op. cit.*, p. 481.

⁸⁵ See the references in *supra*, note 2, as well as the description of various legal systems in the I.C.C. Guide, *op. cit.*, pp. 27–51. The Unidroit Principles accept penalty clauses (“agreed payment for non-performance”) of both natures (indemnity and deterrent), with, *a posteriori*, judicial control. The specified sum may be reduced to a reasonable amount where it is grossly excessive in relation to the harm caused resulting from the non-performance and to other circumstances (Article 7.4.13; cf. M.J. Bonell, Policing the international commercial contract against unfairness under the Unidroit Principles, 3 *Tulane J. Int'l Comp. Law* 1994, 83–85; D. Tallon, Les dommages-intérêts dans les Principes Unidroit relatifs aux contrats internationaux, in *Contratti commerciali internazionali e Principi Unidroit*, M.J. Bonell & F. Bonelli (eds.), Milan, Giuffrè, 1997, pp. 303–304). The Principles of European contract law have a similar provision (Article 9:509); the notes accompanying this article give references to the legal status of penalty clauses in European Union countries (cf. *Principles of European Contract Law*, O. Lando &

penalty clauses inserted in to contracts governed by the laws in question⁸⁶, but not necessarily the contracts themselves.⁸⁷

2. Are these solutions covered, however, by international public policy?

No firm answer seems to be available yet to this very delicate question, as there is little case law. First, three positions from French and Belgian authors can be noted.⁸⁸ As far as Professor Mercadal is concerned, Article 1152, paragraph 2, of the French Civil Code, which provides that excessive penalty clauses may be reduced, comes under French international public policy; that view is based on the equitable nature of the provision, in accordance with the requirements of international trade, and on the fact that it is in conformity with the majority of foreign solutions.⁸⁹ Conversely, Mr. Françon considers that a French court would generally adopt a more moderate approach towards a penalty clause included an international contract than it would in case of a domestic contract, leaving aside certain specific circumstances.⁹⁰ As for M.J. Thilmany, he considers that the solutions in question do not fall under Belgian international public policy; the principle of the prohibition of civil penalties has indeed become less rigorous since *astreinte* was introduced in to Belgian law.⁹¹

As far as case law is concerned, the Working Group was informed of only four decisions. An English court did not find that English law covering “penalties” fell under English international public policy (if this terminology may be used in English law).⁹² In contrast, a German decision⁹³ and a Swiss decision⁹⁴ held that the possibility of cutting down excessive

H. Beale (eds.), the Hague, Kluwer Law International, Parts I and II, 2000, pp. 455–456).

⁸⁶ However, also note that in German law, by virtue of Sections 348 and 351 of the Commercial Code, penalty clauses applicable to a “*Vollkaufmann*” may not be cut down (see M. Strauch, *op. cit.*, p. 499).

⁸⁷ In many legal systems, penalty clauses can be separated from the contract. For instance, under the common law, nullity of the penalty does not result in avoidance of the contract, with the consequence that damages can still be awarded. A contractual “severability” clause can help save the contract when the penalty clause is void; on such clauses, cf. *supra*, pp. 167–176.

⁸⁸ See also M. Strauch, *op. cit.*, p. 499, who raises a similar but not identical problem with regard to Section 344 BGB.

⁸⁹ B. Mercadal, L’article 1152 al. 2 du Code civil est-il d’ordre public international français? *D.P.C.I.*, 1979, pp. 285–289.

⁹⁰ D. Françon, *op. cit.*, p. 481.

⁹¹ J. Thilmany, *op. cit.*, p. 447.

⁹² *Godard v. Gray* [1870] L.R.6.QB 139; P. Ellington, *op. cit.*, p. 507.

⁹³ OLG Hamburg, December 23, 1902, *Seufferts Archiv*, 1902, 63.

⁹⁴ Trib. Féd., February 25, 1915, *Rec. Off.* Vol. 41, II, 138.

penalty clauses, as provided by the Codes of those two countries, was a matter of international public policy. These three decisions are relatively old, however.

More recently, the Paris *Cour d'Appel* held that a penalty clause governed by English law, which had been chosen by the parties, was applicable even though English law did not allow the courts to diminish such a clause; in the case in point, application of the clause was not held to be contrary to French international public policy on the grounds that it itself provided for the penalty to be contractually mitigated.⁹⁵ One commentator considers that, *a contrario*, had that possibility not existed, the court would have disregarded the foreign law that deprived the court of any power of mitigation.⁹⁶

The solutions adopted are still uncertain. Moreover, any generalization would be dangerous, because of the differences between national laws and the importance the courts will attach to the degree of connection of the contract at hand with the national legal system.

3. Are pains taken, in practice, to avoid to the use of penalty clauses liable to be annulled or cut back? The answer to this question is also difficult. While the Group found numerous clauses in which the penalties provided for seemed to be closely aligned with the actual damage, it was unable to recognize definitely “excessive” clauses in the other part of its sample. In fact, it is very difficult to identify such clauses when they are examined out of context. UNCITRAL made the same finding.⁹⁷

Neither is the terminology used any more enlightening. In particular, the expressions “liquidated damages” and “penalty” are often used indiscriminately, even though these expressions determine whether the clause in question will be found valid or invalid under common law.⁹⁸ An example of this confusion follows:

“Section 15. Liquidated Damages.

“This shall comprise the following and be paid in foreign currency.

“15.1. Delay Penalty . . .

“15.2. Performance Penalty . . .”

⁹⁵ Paris, December 22, 1983, *Rev. Crit. Dr. Int. Privé*, 1984, p. 484.

⁹⁶ J. Mestre, note, *id.*, pp. 490–491.

⁹⁷ First UNCITRAL Report, p. 14, No. 36; Second UNCITRAL Report, p. 6, No. 11.

⁹⁸ P. Ellington, *op. cit.*, pp. 507–514; B. Hanotiau, *op. cit.*, pp. 515–524.

Clearly, the court is not bound by the terminology chosen by the parties.

4. Could the parties effectively couple a penalty clause with wording designed to guard against its annulment or risk of being reduced?

Three examples from the Second Report of UNCITRAL's secretariat may be cited:

"In the event the said liquidated damages are held by a Court of competent jurisdiction to be unenforceable for any reason whatsoever, it is hereby agreed and expressly declared that the aforesaid amounts shall be penalties."⁹⁹

That clause is surprising if common law is applicable to the contract (which is possible since the clause is taken from the sales contract concluded between a North American company and a foreign firm); in principle, the sanction is valid if it actually consists of liquidated damages, whereas penalties are null and void.

- "The rates of agreed and liquidated damages shall not be increased or decreased by arbitration."¹⁰⁰
- "The contractor is obliged to pay a penalty to buyer that cannot be reduced by any legal procedure."¹⁰¹

The usefulness of such stipulations is questionable. The provisions from which the parties intend to derogate are, in principle, binding. The question remains whether or not they are covered by the international public policy of the forum.¹⁰²

(b) The validity of a penalty clause may also be affected by the provisions of the applicable law relating to standard form contracts or unfair contract terms. Several of the monographs on national law allude to this. Specific reference is made to the French law of January 10, 1978 and its implementing decree of March 24, 1978,¹⁰³ the British Unfair Contract Terms Act 1977,¹⁰⁴ the German law of December 9, 1976 on general contractual conditions,¹⁰⁵ Section 2-302 of the American Uniform Commercial

⁹⁹ Second UNCITRAL Report, p. 7, No. 12.

¹⁰⁰ *Id.*, p. 21, No. 48.

¹⁰¹ *Id.*, p. 21, No. 48.

¹⁰² Cf. *supra*, pp. 343–344.

¹⁰³ See D. Françon, *op. cit.*, p. 481.

¹⁰⁴ P. Ellington, *op. cit.*, p. 507.

¹⁰⁵ M. Strauch, *op. cit.*, p. 499.

Code as regards the doctrine of unconscionability¹⁰⁶ and the Spanish law of July 23, 1908 on usury.¹⁰⁷ Such regulations may have evolved and others have appeared since those studies were published (the German law on general conditions, for instance, is now incorporated in the BGB). In the European Union, much harmonization has derived from the Directive of April 5, 1993 on unfair terms in consumer contracts.

Some of those provisions are principally concerned with contracts concluded with non-businessmen or consumers, but this is not invariably the case and problems of interpretation exist. Penalty clauses in international contracts could occasionally come under legislation of this type.

(c) Lastly, another type of problem as to the validity of penalty clauses results from the fact that they are frequently used as clauses limiting liability, as observed above.¹⁰⁸ There are restrictions on the validity of the latter type of clauses in most national legal systems, for example, in the case of fraud or gross negligence or where the limitation is such that it undermines the substance of the obligation. We shall be returning to this subject in a later chapter.¹⁰⁹ Here too, negotiators of contracts must be careful. If the penalty clause acts as a clause limiting liability, it will also be subject to the rules governing the latter type of clause, depending on the applicable law.

C. Combination of Remedies

It has transpired from the analysis of clauses that, in some cases, payment of a penalty is stipulated to be capable of being combined with other remedies, such as retention of the obligor's duty to provide specific performance, suspension of the counter-performance, the possibility for the obligee to terminate the contract or the award of additional damages.¹¹⁰

Is such an accumulation of remedies legally valid?

It is indispensable to consider the applicable law, since there are numerous differences.

(a) As regards combining a penalty with specific performance, some legal systems distinguish between a penalty imposed specifically for non-performance, which may not be used in combination (see, for example, Article 1229, paragraph 1, of the French and Belgian Civil Codes and Section 340

¹⁰⁶ B. Hanotiau, *op. cit.*, p. 515.

¹⁰⁷ B. Cremades, *op. cit.*, p. 463.

¹⁰⁸ Cf. *supra*, pp. 338–340.

¹⁰⁹ Cf. *infra*, pp. 382–388.

¹¹⁰ Cf. *supra*, pp. 311–314 and 321–322.

of the German BGB), and a penalty clause relating to delay or defective performance, which may be combined with a right to claim proper performance (Article 1229, paragraph 2, of the French and Belgian Civil Codes; Section 341 of the German BGB).¹¹¹ In the first situation, Article 1153 of the Spanish Civil Code adopts the same solution, in principle, which looks unfavorably upon any combination, but agreement to the contrary is expressly authorized.¹¹² In contrast, some past legislation from Central Europe, specially designed to take account of the needs of international trade, was favorable to the principle of combining penalties and specific performance (Article 192 of the Czech Code of International Trade; Article 304(1) of the East German law on international economic contracts).¹¹³

Manifestly, these few examples cannot exhaust the multiple facets of this problem in comparative law, but they are enough to illustrate the definite divergences that are encountered when dealing with the problems of accumulation of remedies. UNCITRAL's work with a view to drawing up the text of a uniform law came up against the same divergences; they gave rise to considerable discussions within UNCITRAL itself and prompted numerous differing reactions from governments.¹¹⁴ It is possible to endorse the opinion of the UNCITRAL secretariat, which considers that many difficulties of interpretation may be avoided by analyzing the function of the clause: did the parties see it as substitute for performance or as a means of compensating for losses incurred pending proper performance?¹¹⁵ From

¹¹¹ J. Thilmany, *op. cit.*, p. 286; D. Françon, *op. cit.*, p. 481; M. Strauch, *op. cit.*, p. 499.

¹¹² B. Cremades, *op. cit.*, p. 463. Sections 340 and 341 of the BGB would also not seem to be a matter of public policy according to German commentators (see M. Strauch, *op. cit.*, p. 499).

¹¹³ The problem of combining penalties and specific performance clearly arises in different terms under common law where, in principle, specific performance is not granted (see P. Ellington, *op. cit.*, p. 507).

¹¹⁴ See Doc. A/CN.9/219 of 28 May 1982, Nos. 26–30, and Doc. A/AC.9/219/Add., of 23 June 1982, No. 7.

The end result of the uniform rules is a subtly qualified text:

“Article 6:

“(1) If the contract provides that the obligee is entitled to the agreed sum upon delay in performance, he is entitled to both performance of the obligation and the agreed sum.

“(2) If the contract provides that the obligee is entitled to the agreed sum upon a failure of performance other than delay, he is entitled either to performance or to the agreed sum. If, however, the agreed sum cannot reasonably be regarded as compensation for that failure of performance, the obligee is entitled to both performance of the obligation and the agreed sum.”

¹¹⁵ Second UNCITRAL Report, p. 17, No. 39.

this angle, combining compensation for delay and specific performance, for instance, would seem to be generally permitted.¹¹⁶

(b) On similar grounds, the imposition of penalties for delay seems to be compatible with the option often reserved by the obligee to terminate the contract, in whole or in part, if the delay becomes prolonged. The two remedies are not concurrent; they succeed each other in time.

(c) The suspension of correlative obligations may also be validly combined with the stipulation of compensation for delay. The defense of non-performance is only a provisional measure. It is a defense plea open to the obligee but not a mode of compensation, it does not play the same role as a penalty.

(d) What about the case where a penalty is combined with additional damages imposed for the same breach? At first sight, such a combination would appear to conflict with the flat-rate nature of the penalty clause. Article 1152 of the Napoleonic Civil Code, in its original version (this provision has been modified in France and abrogated in Belgium), debarred the courts from granting such additional damages.¹¹⁷ Such a combination is also not allowed under English law.¹¹⁸ But different solutions are adopted in legal systems, which are not bound by a strictly compensatory concept of penalty clauses, despite the possible infringement on the useful nature of flat-rate penalties. The new Article 1152 of the French Civil Code enables the court to increase a manifestly derisive penalty clause.¹¹⁹ In Spain, a combination may be agreed upon by contract.¹²⁰ In Germany (BGB, Section 340)¹²¹ and Switzerland (Article 161(2) of the Code of Obligations, provided that fault on the part of the obligor is proved), the obligee may obtain additional damages if he proves that he has sustained a higher degree of loss or damage. This solution is also adopted in UNCITRAL's uniform rules (Article 7), provided that the loss alleged is "substantially" higher.¹²²

¹¹⁶ See to this effect the Hungarian arbitration award cited in the Second UNCITRAL Report, p. 31, No. 67.

¹¹⁷ See, however, the case law cited by J. Thilmany, *op. cit.*, p. 287, and the distinction introduced by it in order to justify certain such combinations. For France, see the review by B. Mercadal, in *D.P.C.I.*, 1980, 88.

¹¹⁸ P. Ellington, *op. cit.*, p. 507.

¹¹⁹ D. Françon, *op. cit.*, p. 481; see also, p. 433, this commentator's arguments in connection with a particular interpretation of the concept of "*astreintes*."

¹²⁰ B. Cremades, *op. cit.*, p. 463.

¹²¹ M. Strauch, *op. cit.*, p. 499.

¹²² The Benelux Commission (Article 2(2)) and the recommendation of the Council of Europe take the opposite approach.

It is obvious, the various legal systems are very divided in this respect¹²³ and draftsmen of clauses must pay attention to that. A penalty clause stipulated in a contract clearly does not have the same implications if it calls for a definitive lump-sum payment or if it provides an increase by awarding additional damages. It is important to be aware of the solution adopted under the applicable law, and, if need be, to modify it by contract when the solution is not mandatory.

Moreover, the problem warrants consideration from a specific angle when the penalty clause acts as a clause limiting liability. In such a case, the grant of additional damages seems to be precluded, unless the clause contravenes the principles of the applicable law covering the validity of limitation clauses.¹²⁴

IV. CONCLUSION

The subject of penalty clauses has proved to be a particularly vast one. The very concept of a penalty clause is difficult to tie down. There are similarities with numerous similar mechanisms: clauses “for winding up the contract,” liquidated damages clauses, price adjustment clauses, “*astreintes*,” etc. A penalty clause may play various roles and, as a result, come under different rules: functions as a threat, as an indemnity, as limiting liability. Delicate problems can arise with regard to combining penalty clauses with specific performance, termination of the contract and the grant of additional damages. The national legal systems often display marked divergences with regard to these aspects and their mandatory provisions may cause some contractual stipulations to be invalid. Furthermore, analysis of penalty clauses, in practice, shows the great wealth of procedures are available to adapt the drafting of penalty clauses effectively to suit the intended aims, the type of contract and the nature of the obligation to which they relate.

¹²³ For a broader comparative study, cf. T. Segré, *Clause Pénale et dommages ultérieurs en droit comparé*, *Rev. Int. Dr. Comp.*, 1970, pp. 299–311; see also the general references to comparative law with regard to the penalty clauses cited *supra*, p. 299–300; see also the few decisions cited in the Second UNCITRAL Report, p. 31, No. 68.

¹²⁴ Concerning the mechanism of judicial increase of derisive limitation clauses, cf. Ph. Malinvaud, *De l'application de l'article 1152 du Code civil aux clauses limitatives de responsabilité*, in *L'avenir du droit, Mélanges en hommage à François Terré*, Paris, Dalloz, 1999, pp. 689–700.