C. Report of the Secretary-General: liquidated damages and penalty clauses (A/CN.9/161)*

CONTENTS

INTRODUCTION

1. At its tenth session, the United Nations Commission on International Trade Law requested the Secretary-General:

> "to consider, as part of the study on the future long-term programme of work of the Commission which is to be presented at the eleventh session of the Commission, the feasibility and desirability of establishing a uniform régime governing liquidated damages clauses in international contracts".

2. In response to that request, the report of the Secretary-General submitted to the eleventh session on the programme of work of the Commission included a note by the Secretary-General on "Liquidated damages and penalty clauses".[1] This note considered the desirability and feasibility of unifying the rules on liquidated damages and penalty clauses in relation to a wide range of international commercial contracts.

3. At its eleventh session, the Commission considered this note, and decided to include liquidated damages and penalty clauses as a priority topic in its new programme of work. The Commission requested the Secretariat to undertake a preliminary study of this topic.[2] The present report is made in pursuance of that decision.

I. PURPOSES OF LIQUIDATED DAMAGES AND PENALTY CLAUSES

4. In their typical form, these clauses require the payment of a sum of money upon the breach of a contractual obligation.[3] Such clauses are inserted by the parties in their contract with the intention to secure one or more of the following purposes:

(*a*) The amount payable as compensation for breach is determined at the time of contracting. Such an agreed amount eliminates the expenses caused by the proof of loss. Furthermore, because of difficulties sometimes encountered in proving the extent of loss, the amount

* 25 April 1979.

[1] A/CN.9/149/Add.1 (Yearbook ... 1978, part two, IV, A, annex I).

[2] UNCITRAL, report on the eleventh session (A/33/17), para. 67 (Yearbook ... 1978, part one, II, A).

[3] Under many legal systems, clauses requiring the performance of an act other than the payment of money upon breach of a contractual obligation are classed as penalty clauses. Furthermore, the obligation, the breach of which entails the payment of money or the performance of an act, need not arise out of contract but may be imposed extra-contractually, e.g. by statute. These types of penal clauses are not dealt with herein, as they play no significant part in international commercial transactions.

of damages which might be awarded after litigation can be uncertain, and not fully compensatory. An agreed amount is certain, and provides adequate compensation.

(*b*) Fixing the agreed amount at a sum higher than that which the creditor would save by not performing his obligations puts pressure on the debtor[4] to perform, rather than breach, those obligations.[5]

(*c*) The agreed amount serves as the limit of liability of the debtor, and if so desired the amount can be used to fix a lower ceiling of liability than that fixed by the law of damages. The debtor is assisted by knowing in advance his maximum liability exposure.

5. Certainty as to the extent of damages, and the elimination of the expense of proving loss, can be of special importance in international trade contracts. A plaintiff who has to establish his loss in a foreign court may incur considerable expense, and also be uncertain as to the extent of his recovery. In certain circumstances, stimulating performance can also be of great importance. In contracts between parties from States with centrally planned economies great reliance is placed on receiving performance as the system of planning does not readily permit the existence of a market where damages received may be utilized for purchase of substitutes.[6] Developing countries with scarce convertible currency may also find it difficult to find alternative suppliers. Furthermore, non-fulfilment of one item of a development programme can adversely affect the entire programme, but the loss caused may be difficult to quantify, and adequate compensation difficult to recover under the normal rules as to damages.

6. Use of an agreed sum to stimulate performance assumes special importance when the applicable law might refuse specific enforcement of an obligation, e.g. because specific enforcement is an exceptional remedy, or because its grant in the particular case might be contrary to public policy.

II. Definition of liquidated damages and penalty clauses

7. In order to determine the possible scope of uniform rules, it is necessary to examine the relationship between the typical liquidated damages and penalty clauses described above, and other contractual clauses which, while differing in form, nevertheless approximate to the former when they serve the same purposes.

A. *Clauses providing alternative obligations*

8. Such clauses provide alternative methods of performance. However, a clause which fixes the price of goods at $100 payable on 1 January, but gives the alternative of paying $200 on 1 February, could, depending on the circumstances, be interpreted either as a genuine alternative obligation, the higher price reflecting the extended credit given to the buyer, or as a clause providing a sanction for non-performance on 1 January.

B. *Clauses providing for the payment of a sum of money other than on a breach of contract*

9. Contractual clauses may provide for the payment of sums of money other than on breach of contract, e.g. on the promisor's exercise of a right to withdraw from the contract. While such clauses are analytically distinct from liquidated damages or penalty clauses which require payment on breach, they may share the same functions, e.g. in the case of a payment due upon a withdrawal, to compensate the other party for loss resulting from withdrawal, or to deter from withdrawal.

C. *Clauses providing for acceleration of payments*

10. Commercial contracts sometimes provide for the payment of a sum in instalments. They may also provide that, upon a single default, all outstanding payments are payable immediately. While the obligation thereby created is to pay no more than the sum originally due, the greater financial burden of paying all instalments simultaneously would act as a deterrent against default.

D. *Forfeiture clauses*

11. While liquidated damages or penalty clauses provide for the payment of a sum of money upon default, forfeiture clauses provide that a sum of money paid by one party before default (e.g. as a part payment or deposit) is forfeited by that party upon default. Despite this distinction, forfeiture clauses may serve the same function as liquidated damages or penalty clauses: to compensate the party not in default, or to deter the party who is to suffer the forfeit from breach, or both.

E. *Limitation clauses*

12. A clause limiting liability fixes a maximum payable if liability is proved, but not a minimum. A plaintiff must establish the amount of his loss, and if the loss falls below the maximum, only the loss is recoverable. In the case of a liquidated damages or penalty clause, in general neither more nor less than the amount stipulated is recoverable, without proof of loss. To the extent that no more than the amount stipulated is recoverable, such a clause functions as a clause limiting liability.

III. Some common features in the regulation of liquidated damages and penalty clauses

A. *The accessory nature of liquidated damages and penalty clauses*

13. In general, liquidated damages or penalties are only payable if there is liability for non-performance of

[4] Hereinafter, the party liable to pay liquidated damages or a penalty is referred to as "the debtor", and the party entitled to payment is referred to as "the creditor".

[5] In the civil law systems, a clause having the first or both these objects is termed "a penalty clause", and would *prima facie* be valid. Under the common law, a clause fixing the amount of compensation is termed "a liquidated damages clause", and would *prima facie* be valid, while a clause seeking to coerce performance is termed a "penalty clause", and would be invalid. This divergence will be considered below and the use of the term "penalty clause" at this stage does not imply any judgement as to the validity or invalidity of the clause.

[6] Eörsi, "Contractual remedies in socialist legal systems", *International Encyclopedia of Comparative Law*, vol. VII, para. 190; Szasz, *A Uniform Law on International Sale of Goods, the CMEA General Conditions*, pp. 161 and 163.

the principal obligation. Non-performance of the principal obligation may sometimes not entail liability e.g. because the principal obligation is void, or there is a sufficient defence for non-performance, such as *force majeure* or absence of fault, or a requisite *mise en demeure* or other notice has not been given. Since the purpose of liquidated damages or penalty clauses is to recover compensation or inflict punishment for breach of the principal obligation, no liquidated damages or penalties are payable when there is no breach. However, the rules in some legal systems enable the parties by express agreement to make the penalty payable even when non-performance of the principal obligation does not entail liability, e.g. because it is void or because of operative *force majeure* or the absence of fault.

B. *Special regulation to prevent abuse*

14. Many legal systems contain special rules to prevent the use of liquidated damages or penalty clauses to oppress the weaker party in certain transactions, e.g. employment contracts, to protect the employee; contracts of loan, to protect the debtor; and leases of lands and dwellings, to protect the tenant. No unification of these special rules is feasible, since they result from the special conditions and policies of each country, and accordingly these transactions must be excluded from the scope of any unified rules.[7]

IV. Basic differences between the common law and civil law regarding liquidated damages and penalty clauses

15. In the common law, liquidated damages clauses, i.e. clauses by which the parties, at the time of contracting, attempt to fix the amount of compensation payable on a breach of contract, are valid if they satisfy one or more of the following criteria: that the parties genuinely intended to provide for compensation, and not a punishment for breach; that the sum stipulated was a reasonable pre-estimate of the probable loss; and that the loss caused by the breach is impossible or difficult to quantify. Different jurisdictions attach differing degrees of importance to failure to satisfy one or other of the criteria. The courts have no power to vary the amount stipulated in such clauses. In contrast, a clause which, instead of or in addition to the above purpose, seeks to coerce a party into performing his obligation by the threat of a sum payable on breach, is invalid, and the party in breach is only liable for the damages recoverable under the general law.

16. Under the civil law, however, clauses pre-estimating damages or seeking to coerce a party into performing his obligation, or having both these objects, are in principle valid. The courts have the power to reduce the amount stipulated in such a clause in specified circumstances, e.g. if the amount is excessive or there has been part performance.

17. The sharpness of the distinction between the invalidity of clauses seeking to coerce performance in the common law, and their validity in the civil law, is somewhat diminished by the following factors:

(*a*) In civil law systems, penal clauses seeking to coerce performance are sometimes invalidated for reasons of public policy, e.g. as offending good morals, as contrary to good faith, or as providing for the unjust enrichment of one party. In one civil law system,[8] all penal clauses which are purely coercive, and which therefore provide for private penalties, are invalid as being against public policy.

(*b*) Under the common law liquidated damages validly agreed upon might exceed the ordinary damages payable on breach. Where the debtor realizes this before breach, the liquidated damages clause would coerce performance. This would also be the case when the amount of damages likely to be awarded is uncertain, and in the absence of a liquidated damages clause a party might be tempted to breach the contract speculating on a low damages award.

18. Where the primary object of a clause is to limit liability by fixing the sum payable on breach at an amount below that recoverable as damages, both the common law and civil law systems give effect to the clause.[9]

V. Other differences in the rules relating to liquidated damages and penalty clauses

A. *The relationship between recovery of the agreed amount and enforcement of performance*

19. Where there is non-performance or defective performance of an obligation by one party, the law permits the other party in certain cases to enforce performance. When enforced performance is available, the question arises as to the relationship between enforcing performance and the recovery of agreed liquidated damages or a penalty. The solutions differ with the type of breach for which the agreed amount is payable.

(a) *Cases where the agreed amount is payable on complete non-performance of an obligation*

20. Under the common law, the creditor can obtain specific performance, or recover liquidated damages, but

[7] The uniform rules on liquidated damages and penalty clauses adopted by the Council of Europe are contained in an appendix to resolution 78 (3) on Penal Clauses in Civil Law adopted by the Committee of Ministers on 20 January 1978. On this issue, article 8 of the uniform rules is as follows:

"The provisions of the preceding articles shall be without prejudice to rules relating to any particular type of contract owing to its special nature."

[8] In Belgium, where the French Civil Code is in force but without the amendment made in France to the provisions relating to penal clauses by the law No. 75-597 of 9 July 1975, it has been held that only clauses which provide compensation for loss caused by breach constitute penal clauses regulated by the provisions of the Civil Code, which *inter alia* provide that the sum specified in the clause can neither be increased or decreased. See the memorandum on the Penal Clause in Belgian Law drawn up by the Ministry of Justice for submission to the Committee of Experts on Penalty Clauses of the Council of Europe, Document EXP/Clauses pénales (75) 1.

[9] Neither system would uphold the clause if it derogated from a mandatory law prohibiting the limitation of liability. There are other exceptions, e.g. under section 2-302 of the Uniform Commercial Code, such a clause can be invalidated if it is unconscionable, and under French law if the party broke the contract intentionally or with gross negligence the limitation would not apply.

not both. Similarly, in some civil law systems the creditor can enforce either performance, or the penalty, but not both. In other civil law systems, however, while this is the rule in the absence of any agreement on the question, parties can agree that the creditor can enforce both the penalty and performance.

(b) *Cases where the agreed amount is payable on defective performance*

(i) *Cases where the agreed amount is payable for delay in performance*

21. There is general agreement in civil law systems that in such cases the creditor can enforce both the penalty and performance. Similarly, under the common law the creditor can obtain both specific performance of a delayed obligation and liquidated damages payable for delay.

(ii) *Cases where the penalty is payable for other types of defective performance*

22. Some civil law systems provide that in such cases the creditor can enforce both proper performance and the penalty. Other civil law systems provide that both proper performance and the penalty cannot be claimed unless the parties have agreed. In yet other civil law systems in any event only one or the other remedy can be claimed. The last would also be the position under the common law.

B. *The relationship between recovery of the agreed amount and recovery of damages*

23. Since one of the objects of an agreed amount is to avoid the difficulties of an inquiry into damages, the common law and most civil law systems do not permit the creditor, in cases where recoverable damages under the ordinary rules exceed the agreed amount, to waive the agreed amount and claim damages. Nor can the debtor, in cases where the amount recoverable as ordinary damages is less than the agreed amount, assert that he should only be liable for ordinary damages. There are, however, exceptions:

(*a*) Some civil law systems provide that, where the loss exceeds the agreed amount, the creditor can recover damages for the excess if he can prove that the breach of contract resulted from negligence, or an intention to injure.

(*b*) Some civil law systems provide that, where the loss exceeds the agreed amount, the creditor can recover damages for the excess if the parties have so agreed.

(*c*) Some civil law systems provide that, where the loss exceeds the agreed amount, the creditor can recover damages for the excess, unless the parties have agreed to the contrary.

(*d*) Some civil law systems provide that the agreed amount is not due if the debtor establishes that the creditor has not suffered any loss.

(*e*) Although under the common law the fact that no loss, or hardly any loss, resulted from the breach of contract does not in principle prevent the creditor from recovery of the full amount agreed as liquidated damages, in practice there is a tendency in such cases to decide that the clause does not provide a genuine pre-estimate of loss, and therefore, is invalid.

C. *Judicial reduction or increase of liquidated damages or penalties*

Reduction

24. Under the common law a court has no power to reduce an amount validly agreed as liquidated damages. On the other hand most civil law systems give the court the power to reduce penalties, although the scope of the power varies with each system. The following are some of the main grounds on which courts are entitled to reduce penalties:

(*a*) If the obligation has been partly performed by the debtor before breach;

(*b*) If the penalty is disproportionately high, or excessive, or manifestly excessive;

(*c*) If the penalty is unreasonable, or iniquitous.

25. Most of the legal systems permitting reduction do not specify the criteria to be applied in determining whether, for example, part performance justifies a reduction, or whether the penalty is manifestly excessive, or unreasonable. The following are some of the main criteria which have been applied by courts in deciding whether a reduction is justified:

(*a*) The extent to which part performance has benefited the creditor;

(*b*) The extent of the disproportion between the amount of the penalty, and either the value of the actual loss suffered, or the amount recoverable as damages for the loss. This criterion is widely applied;

(*c*) The good or bad faith of the debtor, or the degree of his fault, in committing the breach of contract;

(*d*) Culpable conduct on the part of the creditor, such as failure to take action to mitigate his loss, which might have contributed to his loss;

(*e*) The extent to which the debtor has been enriched by his own breach of contract;

(*f*) The financial state of the debtor, and the effect that payment of the penalty would have on that State;

(*g*) All legitimate interest of the creditor in the payment of the penalty.

26. Under some civil law systems, the court can only reduce the penalty on an application for that purpose by the debtor. In others, the court can reduce the penalty of its own motion.

27. In some legal systems the parties can by agreement exclude reduction. Reduction is also excluded by some systems if payment of the penalty has already taken place. Some systems also exclude reduction where the penalty was stipulated as payable by a trader as part of a business transaction, or if the penalty clause was part of a commercial transaction between merchants.

Limit on penalty

28. Some legal systems control the penalty by providing that its value cannot exceed the value of the principal obligation for breach of which it is payable.

Increase

29. Both common law and most civil law systems do not confer on the courts the power to increase liquidated damages or penalties. At least one civil law system, however, permits the increase of a penalty if the agreed amount is manifestly derisory. It would appear that some of the criteria adopted to determine whether a penalty should be reduced would also be applicable to determine whether it should be increased, e.g. disproportion between the amount of the penalty and the value of the loss, the good or bad faith of the debtor, and the degree of his fault in committing the breach.

VI. SURVEY OF THE USE OF LIQUIDATED DAMAGES AND PENALTY CLAUSES IN INTERNATIONAL TRADE CONTRACTS

A. *General conditions and contracts*

30. In order to determine the nature and extent of the use of liquidated damages and penalty clauses in international trade contracts, a representative selection of general conditions and contracts from the collection with the Secretariat was analysed. The following are the relevant facts disclosed by the analysis:

31. *Total number of general conditions and contracts examined* 167

General conditions and contracts containing liquidated damages or penalty clauses 79

General conditions and contracts not containing liquidated damages or penalty clauses 88

32. *Analysis of general conditions and contracts containing liquidated damages or penalty clauses*

Types of contracts examined: sales, 71; supply of equipment and provision of services, 5; loans, 2; transport, 1.

Types of goods which were the subject-matter of the sales contracts: primary vegetable products (eg., jute, rubber, fibre); primary food products (e.g. cocoa); vegetable oils (coconut oil); grains; vegetables; hides; textiles and manufactured goods.

Kinds of breach for which liquidated damages or penalties were payable, and the number of liquidated damages or penalty clauses for each kind of breach[10]

Delay in delivery of goods by seller .. 24

Delay in payment by buyer 24

Delay in shipment by seller 11

Diminution of price consequent upon quality defects in goods 10

Delay by buyer in taking delivery ... 5

Failure to meet guaranteed standards . 4

Non-delivery of goods 4

Violation by buyer of prohibition of export out of the country of destination 3

Default in general 3

Delay in delivery of technical documentation 2

Non-payment of the price 2

Payment by borrower in advance of the stipulated date of repayment 1

Default in tender of documents 1

Default in shipment by seller 1

Delay by buyer in taking up documents presented by seller 1

Payment by buyer not in accordance with instructions 1

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

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 payments in a particular country and the extent of delay 8

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

By reference to a percentage of the cost of defective goods and to 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

Origin of body drafting the general conditions or contracts

Developing countries of Asia and Africa 7

Socialist States of Eastern Europe ... 30

Western Europe and the United States of America 31

International organizations 11

[10] Many contracts contained more than one kind of liquidated damage or penalty clause.

33. *Analysis of general conditions and contracts not containing liquidated damages or penalty clauses*

Types of contracts examined: sales, 75; concession agreements, 6; hire of services, 4; agency, 1.

Types of goods which were the subject-matter of the sales contracts: primary vegetable products (cotton, timber); primary food products (tea, cocoa, coffee); vegetable oils; grains; vegetables; hides; manufactured goods; animal oils; chemicals and fruit.

Origin of body drafting the general conditions or contract

Developing countries of Asia and Africa	15
Socialist States of Eastern Europe	8
Western Europe and the United States of America	54
International organizations	9
Jointly by a body in Western Europe and a body in a socialist State of Eastern Europe	2

34. The large majority of the documents examined were general conditions or standard contract forms in blank. Firm conclusions cannot be drawn from the printed clauses contained in such documents, as the printed clauses may be amended or rejected before the conclusion of a contract. However, they are evidence of the type of clause which the draftsmen would like to include. The predominance of the sales contract in the sample reflects both the existing composition of the Secretariat collection[11] and the frequency of the sale as an international commercial transaction.

35. Approximately half the documents examined contained liquidated damages or penalty clauses, while half did not. Since in general the same commodities were covered by sales documents containing such clauses and sales documents not containing such clauses, no special correlation seems to exist between the trade in a particular commodity and the use of such clauses. Some of the documents not containing such clauses made the common law applicable to the contract. In such cases, it could only be concluded that the parties did not wish to pre-estimate damages, for clauses seeking to coerce performance, even if considered desirable, would have been omitted because of their invalidity.

36. Where a liquidated damages or penalty clause was found, it could safely be inferred that the parties wished to specify in advance the extent of compensation payable. It could not in general be determined, however, whether the creditor was also seeking to coerce performance, since it is difficult to determine whether a specified amount has a coercive effect without knowing the probable saving to the breaching party from a breach.

[11] Efforts are currently being made to diversify the collection.

37. Penalties were most often stipulated for delay in performance. This may result from the frequency with which delay occurs, and the resulting advantages of quantifying in advance the compensation payable, and seeking to coerce the debtor into timely performance. Methods of calculating the agreed sum, e.g. as a percentage of the value of the goods delayed, or as interest on the unpaid sum, together with a ceiling on the extent to which the sum can increase, have also been devised which to a great extent avoid the possibility of the sum being invalidated as a penal sanction, or reduced as being excessive. In contrast, penalties are not often stipulated for quality defects. This may result from the difficulty of predicting in advance the type of defect that may occur, or the extent of loss likely to be caused.

38. The methods of computing the sum due may be very simple, e.g. a percentage of the sum due, or more complex, and requiring arbitration to ascertain the amount, e.g. a percentage of the value of goods which deviate from guaranteed standards, the percentage varying with the rate of deviation. Nevertheless the expense involved in applying even the more complex methods would probably be less than that involved in an inquiry into damages under the ordinary law.

39. The saving of costs normally effected by the use of liquidated damages or penalty clauses was frequently offset by other provisions, e.g. the agreed sum was sometimes made payable only on proof of actual damage, or a creditor was entitled to damages in addition to the agreed sum. Such provisions reflected a bias in formulation in favour of the party drafting the clause. Proof of actual damage as a precondition to recovery was inserted when the debtor was the draftsman. The availability of damages as an additional remedy was inserted when the creditor was the draftsman.

40. A special examination was made of a selection of the general conditions drafted under the auspices of the Economic Commission for Europe,[12] as these general conditions are intended for use whether the applicable law is the common law or a civil law system. While some of these general conditions provided for the payment of interest for delay in payment, or for a price reduction for delay in completion or delay in delivery, the rate of interest or the rate of the price reduction had to be inserted by the parties. The parties were therefore free to stipulate rates which were only pre-estimates of compensation for loss, or which also coerced performance.

[12] The following 10 general conditions were examined: Contract for the sale of cereals, No. 5A; General Conditions for the supply of plant and machinery for export, No. 188; General Conditions for the supply and erection of plant and machinery abroad, No. 188D; General Conditions for the export and import of sawn softwood, No. 410; General Conditions for the export and import of hardwood logs and sawn hardwood from the temperate zone, No. 420; General Conditions for the supply of plant and machinery for export, No. 574; General Conditions for the supply and erection of plant and machinery for import and export, No. 574A; General Conditions for the erection of plant and machinery abroad, No. 547D; General Conditions of Sale for the import and export of durable consumer goods and other engineering stock articles, No. 730; and General Conditions of Sale for dry fruit (shelled and unshelled) and dried fruit.

B. *General conditions of delivery, 1968-1975, of the Council for Mutual Economic Assistance (CMEA)*

(a) *Areas where penalties are imposed and extensively regulated by the general conditions*

41. Penalties are imposed and extensively regulated in the following instances of delay in the performance of an obligation by the seller: delay in the delivery of goods,[13] delay in the delivery of technical documentation necessary for the operation of plant and machinery,[14] delay in the repairing of defects where the buyer demands repair,[15] and delay in notifying the buyer that a shipment has been made.[16] A penalty is also provided for delay in the opening of a letter of credit by the buyer,[17] and for the period elapsing between the refusal of the buyer to take delivery of defective lots of goods, and resumption of delivery of goods in proper conditions.[18] In all these cases of delay, the amount of the penalty is fixed in the General Conditions by reference to the extent of the delay, and a further criterion, e.g. in the case of delay in delivery of goods, by reference to the value of goods delayed.[19] Where the rates are fixed by the General Conditions or by a bilateral agreement, they cannot be reduced by an arbitration tribunal.[20] Rates fixed by contract can be reduced, on the ground that the absence of the necessary co-operation by the creditor, or the presence of unlawful conduct of the creditor, contributed to the breach by the debtor.[21] As delay increases, so does the penalty, but not beyond a specified maximum.[22] The penalty can be demanded in addition to proper performance. If the contract, a bilateral agreement, or the General Conditions does not establish a penalty for non-performance or unsatisfactory performance, the debtor is bound to compensate for losses thereby caused to the creditor.[23]

(b) *Areas where parties are permitted to impose penalties*

42. Parties are permitted to impose penalties, and fix their rates for non-performance or unsatisfactory performance of his obligations by an obligor.[24] Rates fixed in the contract can be reduced on the grounds noted above.[25] The penalty can be demanded in addition to proper performance.

43. Where the General Conditions impose penalties for breach, they achieve several objectives: coercion of performance and recovery of definitely quantified compensation, by fixing an appropriate amount; elimination of excessive penalties, by fixing a ceiling; and elimination of the expense of ascertaining damages. Where penalties are optionally fixed by the parties, the expense of ascertaining damages is eliminated, and certainty of recovery is promoted by the restricted grounds for reducing penalties.

44. In assessing the penalty provisions of the General Conditions as a model for unification, it should be noted that the General Conditions operate among a group of States with centrally planned economies with close economic co-operation. This facilitates agreement on policy issues such as the need to stimulate contract performance, the desirable rates of penalties, the exclusion of damages as a remedy, and the proper grounds for the reduction of penalties.

VII. THE POSSIBILITIES FOR UNIFICATION

45. The factors impeding the wider use of liquidated damages and penalty clauses may be summarized as follows:

(*a*) Clauses seeking to coerce performance are in principle valid in most civil law systems, but are invalid under the common law;[26]

(*b*) A validly agreed amount can be varied in the civil law systems, but not under the common law;[27]

(*c*) In the civil law systems, the grounds of public policy on which liquidated damages and penalty clauses can be invalidated differ;[28]

(*d*) In the civil law systems the extent to which recovery of the agreed amount can be supplemented by other remedies differs;[29]

(*e*) In the civil law systems the criteria determining the possibility and extent of reduction of an agreed amount differ;[30]

(*f*) Uncertainty as to the definition of liquidated damages and penalty clauses.[31]

46. Express selection of a law to govern the contract would mitigate these uncertainties where the *lex fori* recognizes the applicability of the selected law to determine the effect of such clauses, and does not apply its own rules on the basis of public policy. However, there may be no express selection of a law or, even if there is, the *lex fori* may be undetermined.

A. *Policy differences to be reconciled between the common law and civil law*

47. The most serious impediments to unification are presented by the differences separating the common law from most civil law systems. The common law rule against enforcing the recovery of an amount stipulated to coerce performance appears to be based on the view that the appropriate remedy for breach of contract is the payment of compensation for loss caused by the breach. The need to stimulate performance is regarded as suffi-

[13] Sect. 83 (1) of the General Conditions.
[14] Sect. 84 (1).
[15] Sect. 75 (4).
[16] Sect. 87. The same penalty is payable for failure to notify.
[17] Sect. 67.
[18] Sect. 80 (3).
[19] Sect. 83 (1).
[20] Sect. 67B (3).
[21] Sect. 67B (4).
[22] Sect. 83 (3).
[23] Sect. 67C. Furthermore, in the case where delivery has to be made within a fixed time, and there has either been no delivery within the fixed time, or no elimination of defects or supply of non-defective goods within the fixed time, the buyer has the alternative of recovering a penalty at a fixed rate, or recovering compensation for loss suffered, unless otherwise stated in a bilateral agreement or the contract (Sect. 77 (1) and Sect. 86 (2)).
[24] Sect. 67B (1).
[25] Sect. 67B (4).
[26] See chap. IV above.
[27] *Ibid.*
[28] See chap. V above.
[29] *Ibid.*
[30] *Ibid.*
[31] See chap. II above.

ciently satisfied by the coercive effect of a prospective award of damages. Permitting coercion of performance by the use of penalties is regarded as likely to lead to abuses by economically stronger contracting parties. Refusal to encourage coercion of performance may also reflect the refusal of the common law to order specific performance save in exceptional circumstances. The validity of agreements genuinely intended to fix compensation for breach, despite the fact that after breach the agreed amount is found to be higher or lower than that which is normally recoverable, is justified by the advantages of such agreements, and their legitimate purpose.

48. Criticism of the common law focuses on the desirability in many cases of a higher degree of coercion than that exerted by a prospective award of damages. Criticism is also directed to the uncertainty as to whether agreements fixing damages are valid or invalid,[32] the expense of resolving this issue, and where the agreement is invalid, the consequent expense of determining the extent of damages.

49. The civil law position is supported by reference to the need in many cases to ensure performance because of the inadequacy of damages. Since coercive penalties are created by agreement, effect is given to the will of the parties. Abuses are checked by the power given to the courts to reduce excessive penalties. However, criticism is directed to the uncertainty and expense arising from the possibility of the agreed amount being reduced by the courts and the lack of clarity of the criteria applied in determining the extent of reduction.[33]

B. *Policy differences to be reconciled within the civil law systems*

50. Differences as to the grounds of public policy which invalidate penalty clauses would be difficult to harmonize, since the grounds adopted by each legal system would be based on values of special importance to it. However, invalidation on such grounds does not appear to be frequent, and hence absence of harmony in this area may not involve an unacceptable degree of uncertainty.[34]

51. Differences in the extent to which recovery of the agreed sum can be supplemented by other remedies also reflect policy differences. For example, those legal systems which permit both recovery of the sum agreed and enforcement of performance stress the punitive element in the sum agreed, while others which only grant one or the other remedy lay less stress on this element.[35] Again, those legal systems which only permit recovery of the agreed amount even though the value of the loss exceeds such amount stress the saving of expense caused by eliminating an inquiry as to the extent of loss. Others which permit additional recovery lay stress on the importance of full compensation.[36]

52. The different criteria applied to determine whether an agreed sum should be reduced mainly reflect two policies: prevention of unjust enrichment of the creditor, and the penalization of a party who has been at fault. Limited grounds for reduction promote certainty in the recoverability of the agreed amount, but at the cost of sometimes preventing a reduction that is appropriate.[37]

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[32] The Indian Contract Act, 1872, and the Cyprus Law of Contract, 1930, which is modelled on the Indian Act, though based on the common law, reject the distinction between valid liquidated damages and invalid penalties. Section 74 of the Indian Act provides as follows:

"(1) When a contract has been broken, if a sum is named in the contract as the amount to be paid in case of such breach, or if the contract contains any other stipulation by way of penalty, the party complaining of the breach is entitled, whether or not actual damage or loss is proved to have been caused thereby, to receive from the party who has broken the contract reasonable compensation not exceeding the amount so named or, as the case may be, the penalty stipulated for."

[33] In the harmonization attempted by the Council of Europe through resolution (78) 3 adopted by the Committee of Ministers, the validity of a coercive penalty is recognized. The resolution recommends the adoption of the following definition:

Article 1: "A penal clause is, for the purposes of this resolution, any clause in a contract which provides that if the promisor fails to perform the principal obligation, he shall be bound to pay a sum of money by way of *penalty* or compensation" (emphasis added).

[34] No harmonization of public policy grounds is recommended by resolution (78) 3 of the Committee of Ministers of the Council of Europe.

[35] On this issue, resolution (78) 3 recommends the adoption of the following principles:

Article 2: "The promisee may not obtain concurrently performance of the principal obligation, as specified in the contract, and payment of the sum stipulated in the penal clause unless that sum was stipulated for delayed performance. Any stipulation to the contrary shall be void."

[36] On this issue, resolution (78) 3 recommends the following principles:

Article 5: "The promisee cannot obtain damages in respect of the failure to perform the principal obligation instead of, or in addition to, the sum stipulated."

This article is not mandatory, and the parties can derogate from it by agreement. However, article 6 provides: "Despite any stipulation to the contrary, the promisee cannot obtain a sum in excess of either the sum stipulated under the penal clause or the damages payable for the failure to perform the principal obligation whichever is the larger."

[37] On this issue, resolution (78) 3 recommends the following principle:

Article 7: "The sum stipulated may be reduced by the court when it is manifestly excessive. In particular, reduction may be made when the principal obligation has been performed in part. The sum may not be reduced below the damages payable for failure to perform the obligation."

However, the explanatory memorandum to article 7 states:

"26. It is left to each legal system to determine under what precise circumstances the sum concerned should be considered to be manifestly excessive. It is however, suggested that in a given case the courts may have regard to a number of factors such as:

"(i) damage pre-estimated by the parties at the time of contracting and the damage actually suffered by the promisee;

"(ii) the legitimate interests of the parties including the promisee's non-pecuniary interests;

"(iii) the category of the contract and the circumstances under which it was concluded, in particular the relative social and economic position of the parties at the conclusion, or the fact that the contract was a standard form contract;

"(iv) the reason for the failure to perform the obligation, in particular the good or bad faith of the promisor.

"27. This list of criteria to be taken into account should not be regarded as exhaustive, nor does it indicate any order of priority. When applying the criteria regard must also be had to the general law of contracts in the member State concerned, which may exclude or limit the possibility of using a particular criterion."

This approach may cause an unacceptable degree of uncertainty in trade transactions.

C. *Scope of application of unified rules*

53. The scope of application would need to be clear, and cover the formulations of liquidated damages and penalty clauses commonly used in international trade.[38]

VIII. Conclusions

54. Liquidated damages and penalty clauses serve useful purposes, and are widely used. The case for unification rests on the desirability of ensuring their greater effectiveness. As clauses which only seek to pre-estimate compensation, although somewhat differently treated, are valid under all legal systems, the focus of unification would be the wider recognition of clauses seeking to coerce performance. It is difficult to determine whether, in general, current levels of contract performance in international trade are deficient, and need enhancement. It can be accepted, however, that whatever be the applicable law, contracting parties might for special reasons value the possibility of using, without uncertainty, a liquidated damages or penalty clause to increase the expectancy of performance.

55. Those legal systems which find clauses seeking to coerce performance unacceptable for policy reasons may, perhaps, be disposed to accept uniform rules validating such clauses subject to certain qualifications. Possible qualifications would be restricting the application of the rules to international contracts, excluding their application to consumer contracts, continuing to apply existing rules protecting a weaker contracting party against fraud and coercion and, in particular, making the unified rules applicable only upon express selection by the parties. While the foregoing survey has revealed policy differences on issues other than the coercion of performance, such differences appear to be more readily susceptible to compromise.

56. The benefits of liquidated damages and penalty clauses noted above are applicable to international commercial contracts in general, and not merely to international sales. The formulation of unified rules applicable to a wide range of contracts does not appear to create special difficulties.[38]

57. Two regional attempts at unifying the rules on liquidated damages and penalty clauses have been made, one by the Interparliamentary Consultative Council of Benelux,[40] and the other by the Council of Europe.[41] Both seek to make national law on such clauses conform to the unified rules adopted by them. States adopting these unified rules may find acceptable a limited derogation from them in favour of unified rules applicable to international trade contracts.

58. As to the means by which unification can be achieved, it is clear that legislative intervention is necessary as the differing legal rules have a mandatory character. The drafting of a model clause for adoption by contracting parties would not suffice. It is also apparent that the cost of a diplomatic conference convened solely to adopt a convention containing uniform rules on this topic would be disproportionate to the possible advantages to be gained through the adoption of such rules. An alternative approach is the drafting of a model law to be adopted by States, containing uniform rules. The drafting of such a model law could be referred to a working group on international contract practices.

[38] Resolution (78) 3 recommends the following scope of application:

Article 1: "A penal clause is, for the purposes of this resolution, any clause in a contract which provides that if the promisor fails to perform the principal obligation he shall be bound to pay a sum of money by way of penalty or compensation."

However, paragraph 2 of the resolution also recommends to Governments "to consider the extent to which the principles set out in the appendix can be applied, subject to any necessary modifications, to other clauses which have the same aim or effect as penal clauses".

[39] Both the unified rules of Benelux and the Council of Europe are applicable to all types of contracts.

[40] By the Benelux Convention relating to the Penal clause, done at The Hague on 26 November 1973. The parties to the Convention are Belgium, Luxembourg and the Netherlands. The Convention has not yet entered into force.

[41] By resolution (78) 3 adopted by the Committee of Ministers of the Council of Europe on 20 January 1978.

D. Report of the Secretary-General: clauses protecting parties against the effects of currency fluctuations (A/CN.9/164)*

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* 20 March 1979.