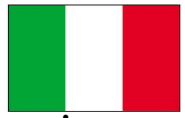
# *Penalty clause*

**Art. 1382, paragraph 1, CC - *Effects of the penalty clause***



The clause by which it is agreed that, in case of non-fulfilment or delayed fulfilment, one of the parties is held to a determined performance, has the effect of limiting compensation for the performance promised, if the compensability for further damage has not been agreed.

**Example:** **Alfa**, a Dutch company, has successfully tendered for the construction of my warehouse, which needs to be completed by March 31. To give a "guarantee", and to avoid, in case of non-fulfilment, to discharge the burden of proving the damage sustained, at the moment of entering into the contract **Alfa** and the other party agree that for every day of delayed handover, € 1.000 will be payable.

**Art. 1382, paragraph 2, CC - *Effects of the penalty clause***

The penalty is payable independently of proof of damage.

The penalty may be payable because of:

***non*-fulfilment**: in which case, unless otherwise provided, it "replaces" the damage.

**delayed fulfilment**: in which case, besides the penalty (for delay), compensation for damage for ***non*-fulfilment** can be sought.

**Art. 1218 CC – *Liability of debtor***

The debtor who does not exactly render **due performance** is liable for damages, unless they prove that the non-fulfilment or the delay was caused by impossibility of performance deriving from a cause not imputable to the debtor.

**Art. 1226 Code civil**

A penalty is a clause by which a person, in order to ensure performance of an agreement, binds himself to something in case of **non-performance**.

**Art. 1229 Code civil**

A penalty clause is a compensation for the damages which the creditor suffers from the **non-performance** of the principal obligation.

He may not claim at the same time the **principal and the penalty**, unless it was stipulated for a **mere delay**.

**Section 341 German Civil Code - Promise of a penalty for improper performance**

If the obligor has promised the penalty in the event that he **fails to perform** his obligation properly, including without limitation **performance at the specified time**, the obligee may demand the payable penalty **in addition to performance**.

**Art. 160 Swiss Code of Obligations**

Where a penalty is promised for **non-performance** or **defective performance** of a contract, unless otherwise agreed, the creditor may only compel performance or claim the penalty.

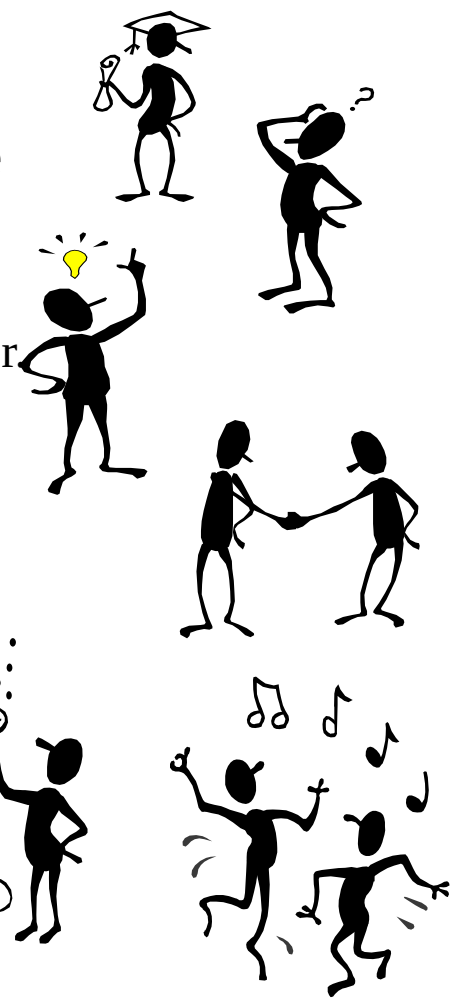
Where the penalty is promised for failure to comply with the **stipulated time** or place of performance, the creditor may claim the **penalty in addition to performance** provided he has not expressly waived such right or accepted performance without reservation.

# *The commutation of the penalty*

You are smart students. You want to end your studies with an excellent thesis and then go on holiday with friends to the Maldives.

However, you're short of money. You need the money you have available for the printing and binding of your theses.

Then you have a good idea. You go to the copy shop, and knowing that binding the theses costs € 800, you propose a new agreement to the binder.



You're willing to pay € 1200 so long as the thesis is perfect without any typographical errors. You tell the binder that you will pay € 1200, but for every typo in the 200-page thesis, they will have to pay a penalty of € 15. Obviously you hope that there will be as many errors as possible.

In fact, considering an average of 6 errors per page, not only will you pay nothing for the printing (6 x € 15 x 200 = 1800 €), but you will also have € 600 (1800-1200 = 600) to "fund" your partying in the Maldives.

⇒ *Is such an agreement admissible?*

**Art. 1384 CC - *Commutation of penalty***

The penalty may be reduced equitably by a judge, if the main obligation has been carried out in part, or if the amount of the penalty is manifestly excessive, having regard to the interests that the creditor had in the fulfilment.

## Art. 1384 CC - *Commutation of penalty*

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**Example:** A fast food chain agrees with its wholesale meat supplier that, should any delivery of meat be substandard, a penalty of € 10,000,000 will be payable.
The same penalty agreed between the same supplier and an individual restaurant, on the other hand, would certainly be regarded as "manifestly excessive".

**N.B:** It is an **extraordinary provision**, because it is in direct ***contrast*** to the principle of **contractual autonomy**.

Penalty clauses are often used in construction contracts: they often provide for the payment of a penalty – by a contractor – in the case of failure to terminate the construction/maintenance works within the agreed term/deadline.

**Example:** A railway company enters into a contract with a contractor in order for the latter to carry out maintenance works to a railway bridge. The works have to be carried out from Saturday 2.00 a.m. to Monday 5.00 a.m. The overall value of the contract is € 600.000,00. Parties to the contract agree that failure to terminate the maintenance works by Monday 5.00 a.m. will result in the payment of a penalty – by the contractor – amounting to € 500,00 for every minute of delay.

## Art. 1385 CC – *Confirming earnest*

If at the time of the formation of the contract, one party gives to the other, as earnest, a sum of money **[…]**, the earnest, on performance, must be returned or imputed to the performance due.

⇒ *Is Art. 1384 CC applicable to the payment of an earnest?*

**Section 343 BGB - Reduction of the penalty**

If a payable penalty is **disproportionately high**, it may on the application of the obligor be **reduced** to a reasonable amount by judicial decision. In judging the appropriateness, every **legitimate interest** of the obligee, not merely his financial interest, must be taken into account. Once the penalty is paid, reduction is excluded.
The same also applies, except in the cases of sections 339 and 342, if someone promises a penalty in the event that he undertakes or omits an action.

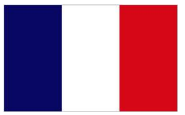
According to the *Bundesgerichtshof* (German Supreme Court **[BGH]**: judgment of June 30, 2003: VII ZR 210/01), in contruction contracts a penalty for delayed performance may not exceed an overall amount of 5% of the contract value or, on a daily basis, 0,15% of the contract value.

**Section 348 German Commercial Code (HGB)**

A penalty agreed to be paid by a mercantile trader in the course of his mercantile business cannot be reduced on the ground of Sect. 343 of the Civil Code.

In extraordinary circumstances German jurisprudence ordered the reduction of the penalty in B2B contracts, i.e. in contracts entered into by businesses: in the case at issue, due to a plurality of breaches of contract, the contractor was under a duty to pay a penalty amounting to € 58 Mil., which has been reduced by the BGH (judgment of July 17, 2008: I ZR 168/05) to € 200.000. Notwithstanding such reduction, the BGH stated it is to be considered the very exception.

**Art. 1231 Code civil**



Where an undertaking has been **performed in part**, the agreed penalty may, "even on his own motion", be **lessened** by the judge in proportion to the **interest which the part performance** has procured for the creditor, without prejudice to the application of Article 1152. Any stipulation to the contrary shall be deemed not written.

**Art. 1152 Code civil**

Where an agreement provides that he who fails to perform it will pay a certain sum as damages, the other party not be awarded a greater or lesser sum. Nevertheless, the judge may even on his own motion **moderate** or increase the agreed penalty, where it is **obviously excessive** or **ridiculously low**. Any stipulation to the contrary shall be deemed unwritten.

⇒ *Is it possible to agree to a penalty clause for completely trifling non-fulfilment?*

**Example:** Against non-fulfilment by the tenderer who has contracted to build me a house, parties to the contract agree that in no circumstances will the tenderer's liability exceed € 500.

**Example:** A bank publishes technical documents in order for any contractor to submit his offer for the construction of the former's new headquarters. At the expiration of the deadline the bank has received 6 offers, for an average price of CHF 120 Mil. One offer is significantly lower (CHF 105 Mil. CHF), but the contractor wants to be released from any liability for non-performance.

**Art. 1229, paragraph 1, CC - *Clause of exemption from liability***

Any agreement that preventively excludes or limits the liability of the debtor for deliberate or grossly negligent non-fulfilment, is **void**.

**Deliberate non-fulfilment:** *the contractor does not even commence the works … and wants to be paid!*

**Gross negligence:** *the calculation related to the stability of the building or to the mixture of the concrete result in severe damage to the building a few years after its construction has been terminated (notwithstanding the breach of other provisions).*

**Mere negligence:** *due to the non-adoption of the most recent construction methods, currently implemented solely in 15% of building sites, water seeps into the building a few weeks after completion of works and after a whole week of interrupted rainfalls.*

The same restriction is applied in France, with reference to French case law, as the *Court de Cassation* has repeatedly stated that there cannot be any exemption of limitation from/of liability for gross negligence (*faute lourde* – cf. Cass. March 15, 1876).

According to Art. 1229, paragraph 1, CC, parties to a contract may agree an exemption from liability in the case the non-fulfillment of the performance is not due to a deliberate or grossly negligent conduct, i.e. is due to **"mere" negligence**.

***i.)*** *The carrier is exempt from liability in the case of the destruction of the goods after an accident whose causes are unclear, provided the carrier can prove that his/her behaviour was diligent (= did not amount to a deliberate or seriously culpable behaviour).*

***ii.)*** *The warehouse owner, in the case of the destruction of stored goods, should be exempt from liability if the causes of a fire are unknown , if the owner's behaviour was diligent (= did not amount to a deliberate or seriously culpable behaviour): that is, there was a fire-alarm installed, a security service at the warehouse, etc.*

**Art. 1229, paragraph 2, CC - *Clause of exemption from liability***

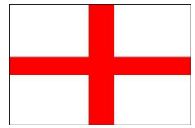
Any preventive agreement that exempts or limits liability for the case where the act of the debtor **[...]** constitutes a violation of obligations deriving from the rules of public policy, is also **void**.

**Example 1:** *The exclusion of the guarantee of authenticity by a bank in a sale of works of art in the interest of third persons was held to be void as it contravened Art. 1229, paragraph 2, CC.*

Collective interest in ***not*** promoting the market of **fake** artworks.

**Example 2:** *Any limitation of liability with reference to personal injury is also* ***void*****!**

# *Agreed damages clause*



English law allows the contracting parties to make their own provision for the consequences of a **breach of contract**. Thus they can insert into the contract a clause which quantifies, or liquidates, the sum payable **on the occurence** of a **breach of contract**.

The Court have reserved to themselves the power to regulate these provisions.

~~**Penalty clause**~~ ⇔ **Agreed damages clause**

If the term in the contract making provision for the payment of damages is held to be a **penalty clause**, it will ***not*** be enforced and the innocent party will be confined to a claim for damages assessed on the the basis of the principles applied by the courts.

On the other hand, if the term is held to be a **liquidated damages clause** then the clause will be **valid** and it will fix the liability of the party in breach, in the sense that the sum stipulated in the clause will be the sum that must be paid, irrespective of the loss that is actually suffered on the facts of the case.

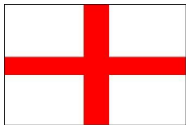
A clause which is held to be a **penalty clause** is not struck out of the contract, but it will ***not*** be **enforced** by the court beyond the actual loss of the party seeking to rely on the clause.

The court automatically relegates the innocent party to a **claim in damages**.

Whether a term is a **"penalty"** or a **"liquidated damages clause"** will depend on the following propositions:

1. **The label used by the parties is *not* conclusive**. Thus the courts can override the label used by the parties if satisfied that it does not reflect the "true" nature of the transaction that has been concluded by the parties.

"We agree to pay to the party X, the sum of … UK£ for each and every … breach of this contract, as and **by way of liquidated damages and *not* as a penalty**, but without prejudice to any rights or remedies you or party X may have hereunder.



**2.** The **second proposition** is that the court must focus attention **on the time of entry** into the contract and ***not*** **the time of breach**, nor the date of the hearing.

This enables parties to **know where they stand** in the sense that the validity of the clause does not depend on future, unknown events.

**3.** The **third proposition** defines the essence of a **liquidated damages clause**.

The test is ***not*** whether it is a **"reasonable" pre-estimate** of the loss but whether it is a **"genuine"** or **"bona fide" pre-estimate**. This is not to say that the reasonablemess of the clause is irrelevant.

It is relevant in the sense that the more unreasonable the clause, the less likely it is that the pre-estimate is **"genuine"**.

**4.** The **fourth proposition** relates to the missing distinction between **serious** and **trifling** breaches by the hirer.

(There is a presumption that it is a penalty when a single **lump sum** is made payable by way of compensation, on the occurrence of one or all of several events, some of which may occasion **serious** and others but **trifling damage**).

"If the contractor commits a breach of **any** of its obligations under the Contract; … the party X may, without prejudice to any accrued rights or remedies under the Contract, terminate the contractor's employment under the Contract by notice in writing having immediate effect."