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TOPIC

THE PECULIARITIES OF CONTRACTUAL PENALTY CLAUSES IN COMMERCIAL CONTRACTS

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LIST OF ABBREVIATIONS

EU – European Union

CC France - Code Civil France

BGB - Bürgerliches Gesetzbuch (The German Civil Code)

ABGB - Allgemeines bürgerliches Gesetzbuch (The Austrian Civil Code)

B2B- Business-to-Business contract

B2C- Business-to-Consumer contract

CJEU - The Court of Justice

UNCITRAL – United Nations Commission on International Trade Law

PECL - Principles of European Contract Law

DCFR - Draft Common Frame of Reference

PICC - the Unidroit Principles of International Commercial Contracts

CISG - The United Nations Convention on the International Sale of Goods

GG – Grundgesetz (German Constitution)

BBiG - Berufsbildungsgesetz (Vocational Education Act)

HGB – Handelsgesetzbuch (German Commercial Code)

Ibid. – Ibidem

art. – Article

para – Paragraph

INTRODUCTION

The relevance of the final thesis. Under the conditions of globalization of the modern world the main object of unification efforts of the international community in the economic sphere remains the legal regulation of commercial relations, which is based not only on international legislation, but also on the national legislation of the countries. The growth of the European Internal Market since January 1993 has not only brought about an increasing number of cross-border contracts, but also a concurrence of different legal cultures and legal traditions, which may now pose new challenges for legislation, jurisprudence and the parties involved. A forward-looking approach to contract law that takes into account the development of the economy and is driven by the will to shape the law can no longer be limited to the domestic legal sphere. In addition to the challenge, this also offers the opportunity to put traditional approaches and solutions to the test and to re-evaluate them from a different perspective.

The consequences of breaches of contract and, in this area in particular, the advance regulation of payment obligations by means of contractual penalties form an essential part of contract law. Particularly in international business transactions, contractual penalties are frequently found in contracts of a more complex nature and/or longer term. This provision has led to a generally accepted understanding of the concept of contractual penalty in case law and literature. A contractual penalty is a promise of performance by the debtor, which results from a contractual agreement with the creditor and ensures that the creditor will receive performance if the debtor does not act in accordance with the contract. The promise of punishment poses a particular risk for the debtor, because the claim for payment can exceed the claim for damages. Therefore, in addition to determining whether the contractual provision can be identified as a contractual penalty at all, the determination and review of the amount of the penalty is regularly the main focus of the attorney's or court's activity. The recipient of the owed performance strives, above all, at the level of the contract, to fix the highest possible amount as the amount of the penalty, without, however, exceeding the limit of an inadmissible increase.

The determination of whether a penalty is disproportionately high is just as much a cause for discussion as the problem of an appropriate penalty amount.

This paper analyzes the limits of contractual penalties under Civil and Common law. The advantages and disadvantages of both approaches are to be elaborated and contrasted in order to be able to reach a conclusion on the best possible model for a uniform, European handling

of contractual penalties.At the same time, the prospects for such a European harmonization of contractual penalty law are to be assessed. The comparison of laws is not limited to an area of application of contractual penalties, but is rather to be understood as an abstract, technical legal consideration from which findings for a general harmonization of European contract law can be drawn.As well as the paper focuses on the handling of contractual penalties in contracts between two companies, i.e., in the business-to-business (”b2b”) area, without completely neglecting the legal situation in contracts between companies and consumers, i.e., in the business-to-consumer (”b2c”) area.

Scientific research problem. The widespread use of penalty clauses in commercial contractual obligations stems primarily from the fact that they are convenient and even universal means of simplified compensation for a creditor's losses caused by a counterparty's non-performance or improper performance of its obligation and as well as different approaches to such agreed contractual non-performance clauses, which cause many difficulties that can also arise in international trade. But this area of litigation is extremely fact-specific; the commercial context of each individual agreement will be taken into account in the court's decision regarding potential penalty clauses. And also the importance of liquidated damages in commercial litigation is caused by the fact that its application in contractual and judicial practice is far from unambiguous. As is the question of whether liquidated damages are disproportionately high, and the problem of the proper amount of contractual penalties.

The novelty of the final thesis. The analysis of previous scientific researchers shows that there are certain ambiguities in the field of determination of contractual penalties. There are works that are either small articles, which briefly explore individual issues related to contractual penalty, or are an integral part of other, larger works, where contractual penalty is considered among other institutions, problems and issues. Scientific novelty of the research is manifested in the rethinking of the institute of contractual penalty in relation to the modern legal and economic realities, in the consideration of the designated institution in close cooperation with the principle of freedom of contract, arising from an even more general principle of dispositiveness. On the basis of a comprehensive analysis, covering the study of foreign experience and historical retrospective, proposed an original approach to the development of objective criteria taken into account in establishing a penalty and conditioning: 1) the legal regulation of the institute of contractual penalty, 2) the specificity of this mechanism in the system of methods of protection of creditor's rights. The proposed criteria of establishing a contractual penalty, which will contribute to a more thoughtful regulation of this

mechanism in a modern market economy. Realization of aspects of application of this institute will allow to use more effectively the legal penalty within the limits of protection of rights of participants. And also shown different approaches found in different legal systems, carefully studied in terms of their practical consequences for the contracting parties.

The level of the analysis of a researched problem of the final thesis. The level of analysis of the investigated problem of the graduation thesis. Despite the large number of works[1] devoted to contractual penalty, almost all of them are either small articles, which briefly explore individual issues related to contractual penalty, or are an integral part of other, larger works, where contractual penalty is considered among other institutions, problems and issues. My master's thesis includes an analysis of civil, common law, and national legislation. The boundaries of the master thesis research include a comparison of the approaches of the EU member states and the UK, and an analysis of the main issue of the master thesis, namely the specifics of the contractual penalty provisions in commercial contracts.

Significance of the final thesis. This research will be useful for scholars and practitioners who are closely involved in the issues of contractual penalties in commercial contracts. Also the master's thesis can be useful for students who want to deepen their knowledge in such complex issues such as problems and features of the application of clauses. The scientific significance of this master thesis research is due to the fact that it:

- represents an attempt to carry out a broad and comprehensive analysis devoted exclusively to contractual penalties;

- contains an analysis of problems and issues related to the application of penalties either requiring a new approach to their solution or only recently faced by the updated civil law and practice of its application;

- contains explanations aimed at understanding the essence of penalties and their correct application by participants in specific legal relations.
Familiarity with this work will allow the participants of commercial relations to more clearly indicate their positions in the obligations, to find the most acceptable forms of their security,

[1] K.W. Clarkson, R.L. Miller and T.J. Muris, "Liquidated Damages vs. Penalties: Sense or Nonsense?", *Wisconsin Law Review* (1978); M. Vitkus, "Penalty Clauses within Different Legal Systems", *Social Transformations in Contemporary Society* 1 (2013); U. Mattei, 1995. "The Comparative Law and Economics of Penalty Clauses in Contracts" *The American Journal of Comparative Law***,** 43, 3 (1995); Garcia, I. M., "Enforcement of Penalty Clauses in Civil and Common Law: a Puzzle to be Solved by the Contracting Parties.", *European Journal of Legal Studies*, 5, 1(2012); E. Peel, "The Common Law Tradition: Application of Boilerplate Clauses under English Law", in *Boilerplate Clauses, International Commercial Contracts and the Applicable Law* and others.

to provide in advance the possible adverse consequences of the improper performance of obligations and minimize them.

The aim of the research is to determine the penalty in commercial obligations, the mechanism of its influence on the obligatory relations, security and compensatory functions of the penalty, the comparative analysis of the rules applied to the penalty in different countries and according to the Principles of International Commercial Contracts, as well as the Principles of European Contract Law. To reveal the essence of the penalty at the modern stage, to determine its place in the system of creditor rights protection, to reveal the objective criteria of establishing a penalty and to identify its practical consequences. As well as identifying the different approaches encountered in legal systems, which are carefully analyzed in terms of their practical consequences for the contracting parties.

The objectives of the research. In order to achieve the goal of this master's thesis it is necessary to solve the following tasks:

-to construct the most complete theoretical model of the concept of penalty, for which the historical development of the penalty as an institution of law was considered and analyzed; the study of the characteristics of the contractual penalty as a measure of responsibility and as a way to ensure obligations;

-to analyze the current legislation of different countries and judicial practice of resolving disputes arising from commercial contracts, as well as analysis of compliance of certain legislation with the general principles of private law, the search for the most acceptable for entrepreneurs interim measures under commercial contracts;

-to determine and outline the range of those legal relations, the implementation of which can be secured by the penalty;

-to identify the main problems associated with the functioning of the institute of contractual penalty;

-to propose for harmonization of legislative acts of common and civil law aimed at improving the current legislation on contractual penalties, using the conclusions of arbitration practice regarding controversial issues of application of norms on contractual penalties in dispute resolution; considering the possibilities and prospects of harmonization.

The defense statement: to identify the similarities and differences between the common law and civil law contractual penalties in terms of their respective nature and methods of action, evaluating the prospects of harmonization of legislation.

The research methodology. Actual scientific research is created with the use of several research methods. The present study used general scientific methods, which include methods of comparison, analysis, synthesis, abstraction, and generalization. Special methods were also used, which include a dogmatic, historical, comparative legal method, method of modeling, subject and functional methods.

The use of a dogmatic method (legal, formal-logical, formal-logical, legal-logical, method of legal interpretation) allowed to identify the exact meaning of the legal norms governing the penalty in a commercial contract. The method of data collection and analysis, is due to the need to study and analyze the provisions concerning contractual penalties in the EU legislation, the national legislation of different countries, as well as scientific articles. The use of the historical method allowed to identify the continuity of regulation, the evolution of the institute of the contractual penalty. The use of comparative-legal method allowed to identify the differences of penalty clauses from similar legal institutions. The use of the functional approach allowed to find out for what purposes the parties use penalty.

The structure of the research. It consists of three main parts:

The first part of the master's thesis examines the historical development of contractual penalties from the fourteenth century to the creation of modern law on penalties. A general description of the concept of contractual penalty is given. It analyzes in historical and comparative legal aspects the subject of penalty, peculiarities of its application and obligation.

The second part of the paper show a comparative analysis of different national approaches and provisions in different national laws will be carried out, the definitions of penalty and its subject that have developed in the legislation of other states will be considered.

The last part will show the problems associated with the law of contractual penalties in common law and civil law, the possibility of harmonization and its prospects.

1. COMPARISON OF CIVIL AND COMMON LAW APPROACHES GOVERNING PENALTY CLAUSE

To date, the penalty is one of the oldest and most common ways to ensure obligations. First of all, the explanation for the effectiveness of the penalty and its wide use to secure contractual obligations in contractual terms is that it is a convenient means of simplified compensation for the creditor's losses caused by the debtor's non-performance or improper performance of his obligations.

The study of penalty clauses is an interesting area of comparative study. Examination reveals diametrically opposed theoretical positions of modern legal orthodoxy in Europe and England. Finding the rationale for this theoretical divergence allows us to understand not only the broader conceptual and substantive differences between these jurisdictions, but also, importantly, their many similarities.

The law of penalty clauses is a perfect illustration of a contradiction present in contract law that has characterized most systems and all periods of contract law history - the conflict between freedom of contract, individual fairness, and legal, and therefore commercial certainty. The dynamic nature of the norms and their constant legal metamorphosis mirror the prevailing philosophical, economic and legal theories of the time.[2]

The present gradual decline of the ” Will Theory ” from its once privileged doctrinal position and the subsequent erosion of the absolute principles of freedom of contract have given greater legitimacy to judicial intervention to protect the individual. It also prompted the courts to resurrect and elaborate on nineteenth-century principles of justice.[3]

This section therefore focuses on the following issues:

1- The diversity of functions reflected in legal terminology.

2- Origins and development in common law.

3- Origin and development in civil law.

[2] D. Mazeaud, *La Notion de Clause Pénale* (Paris: LGDJ 1992) , 31.

[3] D. Ibbetson, *An Historical Introduction to the Law of Obligations* (Oxford: Oxford University Press 1999), 249.

4- Case law: The same facts lead to different results in different jurisdictions.

1.1 The diversity of functions reflected in legal terminology

At the theoretical level, the issue of the dual function, both compensatory and compulsory, is reflected in legal terminology. There are a variety of terms for these clauses, including *clause pénale,Vertragsstrafe, clausula penal, penalty clause, lump sum indemnity clause, liquidated damages clause, clausola penale, liquidazione forfettaria anticipata del danno, stipulated damages clause and agreed amount of advance payment.*

In civil law, they are often used interchangeably because all clauses are valid and enforceable; in the French, Belgian, Italian and Spanish systems and in the Swiss, for example, there is still a tendency to prefer the expression ”penalty clause” in order to legitimize judicial intervention to reduce the agreed amount, although the compensation function seems to prevail in these systems at present. In other civil law systems, such as German, the words used to construct contractual clauses expressing a particular function still mark a significant difference in legal regimes, and two different types of clauses are recognized; when constructed as one-time claims for damages, the judicial power of control is severely limited.

Common law[4] distinguishes between ”stipulated or liquidated damages clauses” and ”penalty clauses”[5] based on their function: stipulated or liquidated damages clauses is used to prejudge damages in the event of a breach, provided that the plaintiff has suffered actual damages, whereas a penalty clause is used to establish the penalty payable in the event of a breach or delay, to induce the parties to perform properly, and does not require proof of actual damages[6]. The former is valid; and the latter is unenforceable.

The question of the validity of the reservation is decisive: the parties must be very careful in assessing stipulated damages clauses, otherwise the common law considers the award of

[4] U. Mattei, ‘*The Comparative Law and Economics of Penalty Clauses in Contracts*’, (Michigan: Michigan Publishing 1999), 43.

[5] K.W. Clarkson, R.L. Miller and T.J. Muris, ”Liquidated Damages vs. Penalties: Sense or Nonsense?”, *Wisconsin Law Review* (1978) : 351–390.

[6] M. Vitkus, ”Penalty Clauses within Different Legal Systems”, *Social Transformations in Contemporary Society* 1 (2013): 153–162, http://stics.mruni.eu/wp-content/uploads/2013/06/153-162.pdf

stipulated damages as a ”penalty” and therefore considered unenforceable. Nevertheless, it is true that at common law, by interpreting the contract in a formalistic way, courts circumvent the prohibition on punitive damages, achieving results similar to the continental pénale clause, where the parties themselves define the payment as ‘reimbursement of stipulated damages’.[7] In civil law, no matter how clear and detailed the contract, courts cannot bypass the full recognition of contractual penalties and invalidate them; courts can only modify the contract and interpret the penalty rules purposively, such as reducing the amount, while - on the other hand - parties cannot exclude by agreement the courts' discretionary power to modify penalties.

Judicial discretion to modestly reduce,and sometimes increase, the amount stipulated by the parties is a core issue in any legal regime: In this respect, terminological clarity and accessibility can have a positive effect on legal certainty.[8]

If the amount is too high compared to the actual damages expected at the time of contract formation, common law courts will simply disregard it . In civil law, judges test the overall reasonableness of a reservation at the time of its execution, not at the time of contract formation, which means that if a reservation seems reasonable retroactively, it can remain in effect even if it was unreasonable retroactively. If the amount is disproportionate and the innocent party can show that the actual damages suffered are much less than that *ex post* estimate, civil law courts will reduce it or increase it if the amount is risky. In other words, civil law courts can modify clauses (usually by reducing the excessive amount stipulated or sometimes by increasing the clearly insufficient amount), and common law courts can declare such agreements unenforceable because of the principle of just compensation.[9]

A stipulated damages clause leaves common law courts with less room for action; in civil law, contractual penalties still leave judges with some discretion as to the equitable mitigation of penalties under the general principle of good faith.

[7] E. Peel, ”The Common Law Tradition: Application of Boilerplate Clauses under English Law”, in *Boilerplate Clauses, International Commercial Contracts and the Applicable Law*, (New York: Cambridge Univ. Press 2011), 129–178.

[8] B. Fauvaque-Cosson and D. Mazeaud, *European Contract Law, Materials for a Common Frame of Reference: Terminology, Guiding Principles, Model Rules* (Munich: Sellier, 2008), 285.

[9] E. Allan Farnsworth, *Contracts* (4th edition, Aspen: Aspen Publishers, 2004), 811 .

1.2 Origins and development in common law.

English case law has not always been reluctant to enforce contracting parties' penalty clauses.[10] At least until the late seventeenth century and the development by the Court of Chancery of a rule that stigmatized them as unconstitutional, punitive obligations were easily enforced by common law courts. In other words, the common law courts insisted on giving the parties the freedom to enter into an agreement and fulfill its terms. The parties were given the right to jointly enter into a bond, which was a sealed document acknowledging the creditor's debt and including a defeasance clause. This bond was strictly enforced, and to secure its enforcement it always contained a promise to pay a certain amount of money in case of breach, regardless of the losses actually incurred. This means that the common law courts did not take into account the fact that the penalty might not reflect the true losses incurred as a result of the breach. In addition, the reason that punitive damages could be enforced before the rule against liquidated damages was developed was because, in theory, their function was to compensate the injured party.

In the common law world, there is a strict distinction between damages clauses and penalties.[11]. Their different nature is based on the difference between them, that is, the former is used for compensatory purposes, while the latter is used to prevent violations. In other words, the damages clause is a real preliminary assessment of the damage, while the penalty clause is provided as in terrorem for the offending party[12]. Although these functions may overshadow each other, especially when used when the intentions of the parties are unclear or when they seek to include both an enforceable and compensatory element in the reservation, the general rule of common law is that a payment clause is enforceable only if it acts as a compensation clause. Thus, although the parties to the contract are free to discuss all issues, common law

[10] Hillman, Robert. "The Limits of Behavioral Decision Theory in Legal Analysis: the Case of Liquidated Damages", in *Cornell Law Review* 85, 3 (2000) : 727, https://scholarship.law.cornell.edu/cgi/viewcontent.cgi?article=1667&context=facpub .

[11] U. Mattei,. "The Comparative Law and Economics of Penalty Clauses in Contracts" *The American Journal of Comparative Law***,** 43, 3 (1995): 427-444.

[12] L. Miller, "Penalty Clauses in England and France: a Comparative Study", *International and Comparative Law Quarterly*, 53, 1 (2004) : 79-106, https://www.jstor.org/stable/3663137?seq=1#metadata_info_tab_contents .

judges retain wide discretion in choosing a remedy [13]. Common law judges tend to avoid any form of punitive damages, in addition to compensatory damages for breach of contract, because, it is argued, ”the mere availability of such a remedy would seriously jeopardize the stability and predictability of commercial transactions, so vital to the smooth and efficient operation of the modern [...] economy”[14].

Common law theory called ”effective breach” makes it clear to us that as long as the aggrieved party receives monetary damages to compensate for its losses in waiting, breach will be more effective than enforcement[15]. Furthermore, according to the common law concept of damages, the damages awarded must compensate the plaintiff and not exceed his or her actual losses. Based on this concept of damages, the House of Lords stated in one of its cases that a contract clause providing for an amount in excess of the creditor's actual loss is improper[16]. Common law judges distinguish liquidated damages from penalty clauses by comparing a clause, which can include either punitive or liquidated damages, to ordinary damages. If there is a significant difference between the two, it can be concluded that a liquidated damages clause is penal and therefore unenforceable[17]. In addition, it is assumed that the contract is silent as to the specific amount to be paid as damages for breach of contractual obligations and the injured party is afforded the usual American law, heavily influenced by the Uniform Commercial Code[18] and Restatement 2d Contracts[19], has articulated two conditions that must be met for a stipulated amount not to fall within the definition of a penalty clause:

1) the stipulated amount must be reasonable. That is, not too disproportionate in light of the parties' expected harm or the actual harm caused by the breach;

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[13] Farnsworth, E. A., ”Legal Remedies for Breach of Contract,” *Columbia Law Review*, 70, 7 (1970): 1145-1216.

[14] ”Dunlop Pneumatic Tyre Co., Ltd. v. New Garage and Motor, Ltd. 1915”. EUR-Lex. Accessed 10 November 2022. https://www.trans-lex.org/302200/_/dunlop-pneumatic-tyre-co-ltd-v-new-garage-and-motor-ltd-[1915]-ac-79/#toc_0

[15] Posner,, R. *Economic Analysis of Law,* (New York: Aspen Publishers,1998): 100-120.

[16] ”Dunlop Pneumatic Tyre Co. Ltd. v. New Garage & Motor Co. Ltd. 1915”, *op. cit.*

[17] McKendrick and Palgrave Macmillan E.,*Contract law (*London: Red Globe Press, 1997).

[18] ”Uniform Commercial Code”, Uniformslaw, accessed 20 November 2022, https://www.uniformlaws.org/acts/ucc .

[19] American Law Institute, *Restatement (Second) of Contracts* (Philadelphia: American Law Institute, 2013).

2) because of subjective estimation, uncertainty, difficulty in providing evidence of damages, or any other measurement problems, it is difficult or impossible to measure - and thus prove - the alleged damages [20].

Consequently, US courts today apply a single criterion of reasonableness, which includes two elements, namely the disproportionality of the agreed amount and the complexity of proving damages, to determine whether the damages clause is valid as a penalty clause. Most other common law countries, such as England, Australia, Ireland and Canada, have similar rules regarding recoverable damages and penalty provisions.

By qualifying a reservation as a fine or compensation for damages in accordance with English law, the court will consider the intention of the parties regarding its purpose in order to determine whether the reservation is really intended to prejudge damages or punish the guilty party for breach of contract. In other words, the court will carefully examine whether the agreed amount that the parties intended to use as compensation in advance (during negotiations and drafting of the contract) is ”extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have followed from the breach”[21].

However, in *Jobson v. Johnson*[22], the English court established different rules from the common law for provisions classified as penalties. Under *Jobson v. Johnson*, if a provision is classified as a penalty, it is not simply excluded from the contract, but ”remains in the contract and [even] can be sued on”[23] . However, the court also added that such a condition ”will not be enforced by the court beyond the sum which represents the actual loss of the party seeking payment”[24].

Following the foregoing, we can conclude that common law courts have held penalty clauses unenforceable, the English court's decision in *Jobson v. Johnson* seems to represent an exception to the common law approach. Under English law, however, a stipulated amount can only be recovered to the extent that it does not operate as a penalty, simply by ”scaling-down”

[20] Hatzis, A. N. ”Having the Cake and Eating it too: Efficient Penalty Clauses in Common and Civil Contract Law.” *International Review of Law and Economics*, 22, 4 (2003) : 381 – 406, https://www.researchgate.net/publication/222522308_Having_the_cake_and_eating_it_too_Efficient_penalty_clauses_in_Common_and_Civil_contract_law .

[21] See Footnote 15.

[22] ”Jobson v Johnson(1988 EWCA Civ J0525-8),” Vlex, accessed 20 November 2022, https://vlex.co.uk/vid/jobson-v-johnson-793588877 .

[23] Ibid

[24] Ibid.

a reservation to the amount of actual damage, whereas if the actual damage is greater, the reservation will act as a limitation of the damage to be compensated [25]. By ”scaling-down” the reservation and applying it to the extent that it does not act as a punishment, the court, in principle, modifies the reservation, which can be seen as evidence of a subtle convergence of approaches between the traditions of common law and civil law, especially since in most civil countries, the judge has the right to limit the provisions on excessive penalties.

1.3 Origin and development in civil law.

Penalties go back to Roman law. In Rome, judgments were always issued for a certain amount of money *omnis condemnatio pecuniaria*. In that time more contractual promises were not directly enforceable, that is, all promises whose fulfillment had no direct monetary value to the recipient. It was then that Roman law came to the aid of the creditor with what is known as an unreasonable or independent penalty. The debtor declared that he would pay a certain amount of money to the creditor if the latter, the debtor, did not perform a certain action. As a consequence, the desired action became not directly, but indirectly enforceable. Roman law also recognized clauses that provided for a provisional assessment of the damages that might be incurred in the event of a breach of obligation, thus helping the creditor by relieving him of the need to prove the losses actually incurred by the debtor as a result of the failure to perform the obligation.

Penalty clauses are known and used in all civil law jurisdictions. Some national legal systems allow the adoption of penalty clauses for both purposes, that is, to put pressure on the debtor to perform his obligation or to deter him from not performing, and also to make it easier for the creditor to compensate for the damages he has suffered. In some civil law countries, once liquidated damages are agreed upon, the creditor does not have to prove the amount of his damages or that he has suffered any damages at all. Because civil law countries adopt both goals, these countries often do not clearly distinguish between penalty clauses and liquidated damages clauses.

[25] Whincup, M. H. *Contract Law in Practice: the English System and Continental Comparisons,* (Denver: Kluwer Law & Taxation Publishers, 1992).

Civil law countries adhere to the same concept, which defines a penalty clause as a provision designed to encourage compliance with contractual obligations.[26] In the civil law system, provisions on penalties can be considered as a type of compensation for damages that cannot be applied in common law countries due to state policy prohibiting provisions aimed at preventing violations by demanding additional compensation for damage. Unlike common law countries, penalty clauses do not necessarily have to be a reasonable estimate of future damages, since civil law judges check the general validity of the penalty clause only during execution, and not during negotiations and contract drafting. This means that if a reservation seems reasonable *ex post*, it can remain in force even if it is unreasonable *ex ante*, which is unlikely from the point of view of common law. In Europe, the provisions on penalties have been enforceable since the Roman Empire, since in classical Roman law there was a rule of literal enforcement of the provisions on penalties to encourage the fulfillment of contractual obligations [27]. The Napoleonic Code, adopted in 1804, followed the above-mentioned rule of classical Roman law on the literal execution of the provisions on penalties. The regime established by the Napoleonic Code did not distinguish between the provisions on penalties and any other contractual provisions. Thus, if the parties included a penalty clause in the contract, it was possible to challenge such a clause only by challenging the entire contract, this was the case at least until 1975. Many European civil codes were based on the Napoleonic Code and provided for similar rules for the literal enforcement of penal provisions.[28].

However, in recent years, the liberal Roman principle of literal enforcement of the provisions on penalties has been gradually abandoned. There is a widespread tendency in European law to narrow the scope of application of the penalty clause and allow courts to reduce its size if they deem it excessive, which often puts the debtor in a worse position by agreeing to the penalty clause. The evolution of continental law shows some degree of convergence between civil and common law, if it is true that the common law courts, as in *Jobson v. Johnson*, are

[26] Ambrasienė, D. et al. "Civilinė teisė", *Prievolių teisė* [Civil Law. Law of Obligations], (Vilnius: Mykolo Romerio universiteto Leidybos centras, 2009).

[27] Zimmermann, R. *The Law of Obligations: Roman Foundations of the Civilian Tradition*. (Oxford: Oxford University Press, 1990).

[28] Garcia, I. M., "Enforcement of Penalty Clauses in Civil and Common Law: a Puzzle to be Solved by the Contracting Parties.", *European Journal of Legal Studies*, 5, 1(2012): 98-123, https://cadmus.eui.eu/bitstream/handle/1814/24818/MarinG127UK.pdf?sequence=1&isAllowed=y .

becoming somewhat more liberal in their interpretation of the provisions on damages in the event of liquidation.

The process of evolution was supported by the Council of Europe, which in 1971 issued the Resolution on Penalty Clauses[29] to recommend the uniform application of penalty clauses for use by member States. According to the ruling, the courts may reduce the amount of penalties if they are clearly excessive or if part of the main contractual obligation under the contract is fulfilled[30]. The Explanatory Memorandum to the Resolution[31], when determining whether the liquidated losses are clearly excessive, provides a list of factors that include: 1) comparison of liquidated losses with actual losses; 2) the legitimate interests of the parties, including the non-material interests of the creditor; 3) what category of contract and under what circumstances it was concluded, with an emphasis on the relative social and economic situation of the parties; 4) whether the contract was of a standard form; 5) and whether the violation was in good faith or unfair. Many European codes, following the Resolution, allowed courts to reduce provisions on excessive penalties, and national courts began to compile lists of criteria similar to those set out in the Explanatory Note for determining provisions on excessive penalties.[32]

Thus, the Resolution can be considered as a European civil law model of penalty clauses, provided that the main characteristics are: 1) the validity of penalty clauses that may lead to the compulsion of the party to fulfill its contractual obligations; 2) judicial review of penalty clauses on the basis of apparent excess or partial performance; and 3) the right of the creditor either to a penalty or to specific performance, except in the case of default.

Although there is a common understanding of penalty clauses in civil law countries, particularly with respect to their dual purpose, the rules regarding the relationship between penalty clauses and claims for damages vary considerably. In most civil law countries, a stipulated payment replaces a general claim for damages for improper performance or non-performance, with the result that the creditor cannot alternatively claim damages even if it can

[29] "Resolution No. (78) 3" , adopted by the Committee of Ministers of the Council of Europe on 20 January 1978 ,accessed 20 November 2022, https://rm.coe.int/0900001680505599 .

[30] Ibid. Article 7.

[31] "Explanatory Memorandum", prepared by a Committee of Experts on Penalty Clauses in Civil Law 1978, Vanderbilt,accessed 20 November 2022, https://catalog.library.vanderbilt.edu/discovery/fulldisplay/alma991034232889703276/01VAN_INST:vanui .

[32] "Supreme Court of Lithuania, Civil Cases Division, No 3K-7-304/2007".

prove them and they have arisen in excess of the stipulated payment. A claim for damages under general principles of damages law is only possible if the parties have expressly agreed that the creditor may make such a claim.

In principle, most civil law countries agree on how the injured party's right to demand performance of an obligation and its right to demand an agreed payment are related. Generally, the distinction is made depending on the purpose of the penalty clause. If it serves to punish the debtor for failing to perform the obligation, once the creditor demands the penalty, he can no longer demand performance. This is not the case if the penalty is intended to ensure proper, particularly timely performance. Then the liquidated damages and the demand for performance can be summed up.

In general, even though there is some degree of similarity between the common law and civil law systems, a contractual provision punishing one party for non-compliance - performance or breach of contract - will still meet with different reactions in common law and civil law countries. Most common law courts, based on the principle of just compensation, can still declare a penalty clause unenforceable, while civil law courts can only reduce the excessive amount.

1.3.1 Differences in Civil Law Systems

Regardless of the differences in the formal rules contained in the Civil Code and the Commercial Code, where they exist, the results are similar in practice.

However, significant differences at the level of formal rules do exist, but without converging solutions, for example:

- The question of *ex officio* judicial intervention remains open: in France, for example, it is allowed under the 1985 reform,[33] while in Italy it is recognized as Supreme Court case law but is challenged by jurists,[34] and in Spain it is rarely allowed.

- Some legal systems prohibit cumulative remedies, others do not. In the first group of systems, the injured party is not entitled to both penalty and performance of the obligation. In France, there is one exception: the penalty for breach of obligation due to delay under Article 1229(2) CC France which is not a cumulative penalty because the creditor will never receive timely performance of an obligation that has already been belatedly performed.[35] The same exception can be found in the BGB, in section 341(1), which allows a claim for performance in addition to the penalty payable if the penalty was promised for improper performance.[36] The Italian Civil Code: Art. 1383[37], the Portuguese Civil Code: Art. 811[38] and ABGB: Art. 1336.1[39] follow the French solution, while the Spanish system allows cumulative liquidated damages if this right has been expressly granted by the parties' agreement: Art. 1.153 [40].

- The compensatory function of penalty provisions, has led civil law judges to include additional or supplementary damages by agreement of the parties; on the other hand, German courts allow the creditor to sue the debtor for additional damages if the damages are proven.

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[33] "Law No. 85-1097 of 11 Oct. 1985 (JO 15 Oct. 1985 11982)", Ulisboa, accessed 20 November 2022, https://www.fd.ulisboa.pt/wp-content/uploads/2014/12/Codigo-Civil-Frances-French-Civil-Code-english-version.pdf .

[34] Venchiarutti A., "The Recognition of Punitive Damages in Italy: A commentary on Cass Sez Un 5 July 2017, 16601, AXO Sport, SpA v NOSA Inc", *Journal of European Tort Law* 9, 1 (2018) :104-122, https://www.researchgate.net/publication/324972209_The_Recognition_of_Punitive_Damages_in_Italy_A_commentary_on_Cass_Sez_Un_5_July_2017_16601_AXO_Sport_SpA_v_NOSA_Inc .

[35] "French Civil Code", Trans-Lex, accessed 20 November 2022, https://www.trans-lex.org/601101/_/french-civil-code-2016/ .

[36] "Bürgerliches Gesetzbuch", Gesetze, accessed 20 November 2022, https://www.gesetze-im-internet.de/bgb/__341.html .

[37] "Italian Codice Civile" , Trans-lex, Accessed 20 November 2022, https://www.trans-lex.org/601300/_/italian-codice-civile/ .

[38] "The Portuguese Civil code", accessed 20 November 2022, https://www.indiacode.nic.in/bitstream/123456789/8312/1/ocrportuguesecivilcode.pdf .

[39] "Austrian Civil Code", Tras-Lex, Accessed 20 November 2022, https://www.trans-lex.org/602100/_/austrian-civil-code/ .

[40] "Spanish Civil Code" , Vipolex, Accessed 20 November 2022, https://wipolex.wipo.int/en/text/221320 .

In all of these cases is clearly visible the creativity of the judiciary, even in civil law countries: despite the formal rule of law, judges set aside the literal meaning of legal rules to follow implicit inferences in a hermeneutic process.

1.3.2 Legal diversity arising in practice in business-to-business and business-to-consumer contracts

Parties may stipulate in advance to damages as a remedy for breach or delay in performance to avoid having to gather evidence before a civil trial. The parties may also provide for a penalty to the defaulter in the form of a lump sum payment unrelated to the actual damages incurred in order to encourage compliance or deter non-compliance. In other words, the contract may include provisions with either a clear compensatory or deterrent function, or with the intention of combining both functions.

In a growing number of cases (residential leases, product warranties, service contracts with disclaimers) contractual penalties are included in contracts entered into without individual negotiations (so-called B2C), where only one party, the business, stipulates and imposes a standard clause, such as a 'indemnity clause' , on the consumer at the time of contract formation. Article 3(3) of Directive 93/13[41] on unfair terms refers to the Annex, which contains a non-exhaustive list of terms that can be considered unfair. Among them, we find any contractual provision that requires defaulting consumers 'to pay a disproportionately high sum in compensation'.

The Court of Justice ("CJEU") has held in this regard[42] that, although inclusion in the Annex is not in itself sufficient to automatically establish that the challenged condition is unfair, it is nevertheless an essential element on which a competent (national) court may base its assessment of the unfair nature of the condition. In a recent case, the CJEU has clarified an important issue related to "penalty clauses": a national court may exclude the application of

[41] "Council Directive 93/13/EEC of 5 April 1993 on unfair terms in consumer contracts" , Eur-Lex, Accessed 20 November 2022, https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A31993L0013 .

[42]"Nemzeti Fogyasztóvédelmi Hatóság v. Invitel Távközlési Zrt (Case C-472/10) ", Curio, Accessed 20 November 2022, https://curia.europa.eu/juris/liste.jsf?num=C-472/10 .

any unjust condition in a contract against a consumer, but is not empowered to modify the content of that condition.[43]

In particular, if a national court finds that a penalty clause in a contract concluded between a seller (or supplier) and a consumer is unfair, it cannot reduce the amount of the penalty imposed on the consumer; it can only exclude the application of the clause in its entirety to that consumer.

The second part of Article 6(1) of Directive 93/13[44] effectively states that a contract concluded between a seller (or supplier) and a consumer is binding on the parties 'upon those terms' if it is 'capable of continuing in existence without the unfair terms'. The contract must continue to exist, in principle, without any modification other than those resulting from the removal of the unfair condition, insofar as, under domestic law, such continuation of the contract is legally possible.[45]

In general, European consumer protection has introduced a number of restrictions on freedom of contract, which in B2C contracts have led to new remedies not provided for in national law or civil codes before the transposition of the consumer Directives. For contractual penalties, the remedy is that of nullity, to protect the consumer.[46] Thus, in B2C cases, national courts can only remove these clauses; they cannot change their content.

1.4 Case law: The same facts lead to different results in different jurisdictions

This section presents a number of cases to illustrate how jurisdictions differ, using U.S., French and Spanish cases as examples, in deciding a dispute involving a fixed amount agreement for breach of contract, regardless of whether damages or contractual penalties are involved. The issues involved in resolving the problems of an unreasonably small agreed amount, a

[43]"Dirk Frederik Asbeek Brusse, Katarina de Man Garabito v. Jahani BV *(*Case C-488/11, 2013)", Curio, Accessed 20 November 2022, https://curia.europa.eu/juris/liste.jsf?num=C-488/11&language=EN .

[44] See footnote 40.

[45] "Banco Español de Crédito, SA v Joaquín Calderón Camino (Case C-618/10)",Curio, Accessed 20 November 2022, https://curia.europa.eu/juris/liste.jsf?num=C-618/10 .

[46] "Bürgerliches Gesetzbuch",op. cit.

disproportionate agreed amount, and the right of the promisor to both the agreed amount and specific performance are discussed.

Disproportionate Agreed Amoune: Speaking of American state law, parties are in a state of uncertainty because courts may approach the single reasonableness test differently. For example, in *Bruce Builders, Inc. v. Goodwin*,[47] the Florida Court of Appeals upheld the provision on damages, according to which the buyer of eight real estate plots totaling $ 173,800 lost a conditional deposit of $ 7,200, although the seller's net profit was approximately $ 2,500. In the Bruce Builders case, the Florida Court of Appeals argued that the amount of outstanding damages did not shake the conscience of the court (the deposit was about 4% of the total price), and this damage for violation could not be determined at the time of the conclusion of the contract.[48] In contrast, in *Walter Implement, Inc. v. Focht*,[49] he Washington State Supreme Court ruled that a damages provision requiring payment of 20% of unpaid rent under agricultural equipment lease agreements is unenforceable, even though the damages reimbursed amounted to $8,645.06, and the actual damage amounted to about $15,000.[50] In fact, the court recognized the compensated damage on the basis that the amount of the compensated damage was not reasonably related to the damage and that the actual damage was easily determined, which indicates a downward bias of 40%. As for French legislation, despite despite the Civil Code - Article 1152,[51] judicial intervention is exceptional if the punishment constitutes an unjustified abuse of the law enforcement function. *The Cour de cassation* tends to overturn those decisions of the Court of Appeal in which the punishment is recognized as ”manifestly excessive” and, therefore, moderate, since there are no factual grounds for the application of Article 1152.[52] Nevertheless, Article 1152 can be applied to reduce a disproportionate fine on fair grounds:[53] for example, *the Cour de cassation* confirmed the decision of the Court of Appeal to reduce from 30,000 to 22,900 euros the fine stipulated in the contract for the sale of the building on loan terms.[54] Only 22,900 euros of the total deposit were to be confiscated, but the buyers demanded a larger reduction, which *the Cour de*

[47] ”Bruce Builders, Inc. v. Goodwin (No. 73-1142 (1975))”, CaseText, Accessed 20 November 2022, https://casetext.com/case/bruce-builders-inc-v-goodwin .
[48] Ibid.
[49] ”Bruce Builders, Inc. v. Goodwin(No. 73-1142.)” ,CaseText, Accessed 20 November 2022 ,https://casetext.com/case/bruce-builders-inc-v-goodwin .
[50] Ibid, calculation made by the Washington Supreme Court in the last paragraph of the decision.
[51] See footnote 34.
[52]Ibid.
[53] Ibid.
[54] ”Cour de cassation, civile, Chambre civile 3,06-21.145(2008)”, accessed 20 November 2022, https://www.legifrance.gouv.fr/juri/id/JURITEXT000018073976 .

cassation considered sufficient to refuse due to their passive behavior, since the buyers did not meet the deadline even after a two-year extension, despite the quick sale of the property at a good price.[55] On the other hand, the Spanish Supreme Court even ruled that the fact that the amount set is disproportionate or outrageous has nothing to do with reducing the fine in light of article 1154 of the Civil Code.[56] In Spanish law, advances that operate bilaterally in the event of breach by one of the parties, i.e. money to be forfeited by the recipient or a double amount to be returned to the depositor, are considered penalties and, therefore, these amounts are subject to judicial reduction under Article 1154.[57] Thus, the Supreme Court ruled that article 1154 was applicable to the deposit agreement, but refused to reduce the amount of 8,000,000 pesetas (48,080.97 euros) that the seller had to pay to the buyer due to the seriousness of the violation - the pre-sale of the apartment to a third party.[58]

An unreasonably small stipulated amount: the general rule in American state law is that the amount stipulated in a valid liquidated damages clause limits liability arising from a promisee's breach of duty,[59] and the injured promisee has no other remedy to recover a portion of the damages beyond the stipulated amount.[60] However, unreasonably small stipulated amounts fall under the exception under the doctrine of unconstitutionality:[61] "a term that fixes an unreasonably small amount as damages may be unenforceable as unconscionable".[62] In this way, *in Roscoe-Gill v. Newman*,[63] the Arizona Court of Appeals it is considered an unjustifiably small damages clause in the light of the doctrine of unconstitutionality, even though the court concluded that the facts stated by the seller do not make the damages clause unconstitutional: in the contract of sale of a ranch worth $380,000, the buyer lost $5,000 deposited as a deposit in case of default, and the seller demanded $ 140,000 in damages.[64] In French law, Article 1152 can also be applied to increase ridiculously low penalty (*"dérisoire*

[55] "Cour de Cassation, Chambre commerciale, (du 11 février 1997, 95-10.851)", Legifrance, accessed 20 November 2022, https://www.legifrance.gouv.fr/juri/id/JURITEXT000007038457/ .
[56] See footnote 39.
[57] Silvia Díaz Alabart, "Las arras (I)", *Revista de Derecho Privado* 80,3(1996): 37.
[58] Francisco Jordano Fraga, *La Resolución por Incumplimiento en la Compraventa Inmobiliaria*, (Civitas 1992): 187.
[59] "Wechsler v. Hunt Health Systems, Ltd.(330 F. Supp. 2d 383 (S.D.N.Y. 2004))," Casetext, accessed 20 November 2022, https://casetext.com/case/wechsler-v-hunt-health-systems-5 .
[60] Ibid.
[61] American Law Institute, *Restatement (Second) of Contracts* (Philadelphia: American Law Institute, 2013), https://opencasebook.org/casebooks/3665-contracts/resources/5.7.3.1-restatement-second-contracts-356/ .
[62] Ibid.
[63] "Roscoe-Gill v. Newman, 937 P.2d 673 (1996)," Casemine, accessed 20 November 2022, https://www.casemine.com/judgement/us/591481d5add7b0493448b308 .
[64] Ibid.

peine") on equitable grounds,[65] . In this context, *the Cour d'appel of Pau* refused to find a ludicrously low penalty of €24,880 paid to the real estate agency for breach of the exclusive right of sale, because this amount represents more than 16% of the price at which the owners themselves sold the property (€152,400).[66] In its suit, the real estate agency seeks additional damages of €48,000 to compensate for its financial losses. Unlike French law, the basic principle of Spanish law is the literal execution of the contractual penalty - Article 1152, with the sole exception of partial execution,[67] so the courts are in no way allowed to increase the unreasonably low stipulated amount. However, in Spain there is a position according to which the injured party has the right to receive full compensation regardless of whether the violation is intentional and not negligent, since the prohibition on waiving claims for damages resulting from an intentional violation of Article 1102 [68] will make the contractual penalty unenforceable in such circumstances.[69] Alternatively: regardless of Article 1102, the fine is enforceable, despite the willfulness of the violation, but the promise has the right to recover excessive damage.[70] In any case, even if the violation is intentional, Spanish case law confirms the literal execution of the punishment, which does not allow the promise to claim excessive damages.

The right of the promisee both to the amount agreed upon and to the specific performance of the obligation : American state law discusses the validity of *"non-exclusive clauses."*. *Non-exclusive clauses"* are contractual provisions that entitle the promisor to receive the agreed upon amount and any other remedy, whether specific performance or general damages. Nevertheless, the former combination deserves different consideration than the latter. As to specific performance, the non-exclusive clause is void because the parties cannot alter the restrictive nature of that remedy, which in any event may be granted by the court, unless the parties intended liquidated damages to be the exclusive remedy for the breach.[71] In *Stokes v. Moore*, the Supreme Court of Alabama enforces a $500 liquidated damages clause for an

[65] See footnote 34.
[66] "Cour d'appel de Pau, 06/03137 (2008)", Legifrance, accessed 20 November 2022, https://www.legifrance.gouv.fr/juri/id/JURITEXT000019609350?dateDecision=01%2F01%2F2008+%3E+13%2F05%2F2008&isAdvancedResult=&page=2&pageSize=10&pdcSearchArbo=&pdcSearchArboId=&query=*&searchField=ALL&searchProximity=&searchType=ALL&sortValue=DATE_DESC&tab_selection=juri&typePagination=DEFAULT .
[67] See footnote 39.
[68] Ibid.
[69] Marín García, Ignacio, *La liquidación anticipada del daño. Análisis económico de la cláusula penal* (Madrid: Agencia Estatal Boletín Oficial del Estado, 2017): 145-148.
[70] José María Manresa, *Comentarios al Código Civil Español Vol. 2* (Madrid:Forgotten Books,2018) : 239.
[71] Dan Dobbs, *Law of Remedies: Damages - Equity - Restitution* 2nd Edición (Minnesota: West Publishing Co., 2007): 189-201.

employee's breach of a noncompetition agreement against his employers in Mobile within one year of termination, and grants a temporary injunction because the court concluded that the parties never intended liquidated damages as the sole remedy.[72] However, the injured party will never be entitled to both liquidated damages and general compensation. A stipulation with this content is considered punitive because it is disproportionately beneficial to the promisor. For example, *in Schrenko v. Regnante*, the Appeals Court of Massachusetts found a penalty clause providing for forfeiture of a deposit of $16,000 if the buyers defaulted plus damages, in a failed real estate purchase and sale contract in which the sellers received $25,000 more than the buyers would have paid.[73] Under French law, the prohibition on cumulative penalty controls, with the sole exception of penalty clauses for delay - Article 1129.[74] Therefore, French courts will never grant both penalty and performance of the obligation breached to the injured party. It makes sense tha *the Cour de cassation* held that this prohibition necessarily applies only to the same obligation. In other words, if the promisor has breached two obligations, the aggrieved promissee may claim penalty arising from the breach of one obligation and performance of the other. For example, in a computer equipment rental agreement, *the Cour de cassation* affirmed a decision in which, in addition to the amount of unpaid rent, the breaching tenant was ordered to pay agreed compensation in the event of termination.[75] In contrast, Spanish law permits cumulative penalties according to Article 1553,[76] so the injured party may be jointly entitled to penalty and performance of the obligation. Far from being the default rule, the high degree of coercion of the obligated person and the wording of Article 1553 *"unless this power has been clearly granted"* suggest that cumulative penalty are never contemplated. Thus, if contract penalties, as an exception to the general rules of contract law, deserves a narrow interpretation, then the interpretation of cumulative penalties must be even narrower. Under this much stricter standard, the Spanish Supreme Court has recognized as cumulative penalty a clause providing for an additional payment of 15,000,000 pesetas (€90,151.82) in the event of delay or failure to construct two naves.[77]

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[72] "Stokes v. Moore 77 So. 2d 331 (1955)", Justia, accessed 20 November 2022, https://law.justia.com/cases/alabama/supreme-court/1955/77-so-2d-331-1.html .

[73] "Michael Schrenko & another vs. Theodore C. Regnante & others." Casemine, accessed 20 November 2022, https://www.casemine.com/judgement/us/59148ab5add7b0493451670d .

[74] See footnote 34.

[75] "Cour de cassation 88-19.293 (1990)", Legifrance, accessed 20 November 2022, https://www.legifrance.gouv.fr/juri/id/JURITEXT000007097954?isSuggest=true .

[76] See footnote 39.

[77] Ibid.

2. APPLICATION OF CONTRACTUAL PENALTY CLAUSES IN COUNTRIES

2.1 Contractual Penalties in German Law

Sections 339-345 of the Bürgerliches Gesetzbuch (BGB)[78], German Civil Code, expressly permit penalty clauses. Penalty clauses are no more strictly controlled than any other clauses. But rather unusually for German law, the BGB allows the courts to review the application of the penalty provisions on a case-by-case basis and, if necessary, to reduce the amount of the penalty.

2.1.1 Definition according to German law and the functions

Penalty clauses are considered conditional promises. The debtor promises to provide performance if he does not act as he intended. Penalty usually consist of payment to the creditor, but the parties may agree on another form of penalty, such as payment to a third party (e.g. a charitable organization), the delivery of goods or the performance of services pursuant to Art. 342 BGB. The penalty does not necessarily have to be determined in advance; the parties may grant the creditor the right to specify the penalty in accordance with the principles of good faith pursuant to Art. 315 BGB. In such a case, the court checks whether the penalty specified by the creditor is fair. If not, it is not mandatory and its amount is determined by the court.

As to the conditions under which the penalty shall accrue, the parties may determine at their discretion in the contract when the penalty accrues. In the absence of a contractual determination, § 339 BGB shall apply. If the debtor has stipulated a contractual penalty on the condition that he fails to perform or performs improperly, the penalty shall be due in the event of default in performance pursuant to § 286 BGB. If penalty s are stipulated on the condition that the debtor performs a certain act (e.g., on the condition that the debtor breaches the obligation to refrain from competition), then the penalty is triggered if the debtor performs the relevant act.

[78] See footnote 40.

Although the BGB does not explicitly state this, the prevailing view is that liquidated damages only accrue if the debtor acted negligently or intentionally.[79] This limitation stems from the general principles of German liability law, which requires fault; strict liability is an exception in German law. It is debatable whether the parties can contractually deviate from this rule. Deviation by standard business terms is usually invalid because it is contrary to the basic principles of the statutory rules under 307 BGB.[80] However, the Supreme Court allows deviation if it is subject to individual negotiation.[81] This is consistent with the principle of freedom of contract. Nevertheless, some authors argue that if the debtor must pay regardless of his fault, then his promise can be interpreted not as a penalty but as a guarantee. Therefore, they hold that the rules on penalty - especially the court's right to reduce the penalty - are inapplicable unless the parties have agreed to apply them.[82]

Speaking of debtor protection, it is clear that penalty clauses are dangerous to the debtor. In particular, when entering into a contract, the debtor is likely to fail to properly assess the risk that a penalty clause imposes on him, because he usually assumes that the penalty will not occur and tends to ignore the penalty clause. In such a situation, the debtor may be protected by the Statute of Frauds, which provides that the penalty clause must be in writing or notarized. German law, however, takes a different path. A penalty clause is not subject to any special form requirements. Instead, only the general restrictions on freedom of contract apply.

According to German law, there are three functions of penalty clauses: deterrence, compensation, exclusion of injunctions.

Considering the first function of deterrence, it can be said that penalty clauses are designed to influence the behavior of the debtor, to make him adhere to his obligation. Undoubtedly, the debtor who has not fulfilled his obligation must compensate for damages. However, this remedy is not always sufficient to compel the debtor to fulfill the obligation. The doctrine of economic analysis shows that an obligation must be performed if the value of such performance is less than the creditor's expected loss in the event of nonperformance. However, the debtor calculates differently to decide how much to invest in its performance. For the debtor, the

[79] Erman Alexander Walter, *Bürgerliches Gesetzbuch Kommentar* (14th edn, Köln: Dr. Otto Schmidt, 2014): 339.

[80] Erman, supra note, 79: 340-345.

[81] Ibid.

[82] V. Rieble, *J. von Staudingers Kommentar*,(Berlin: Otto Schmidt/De Gruyterб 2020) : 318.

creditor's expected loss does not matter; what matters is his own expected loss. This debtor's expected loss in the event of default may be much lower than the creditor's expected loss. First, the likelihood that the debtor will have to pay damages is almost certainly lower than the likelihood that the creditor will suffer damages. The creditor may not go to court because he does not have sufficient financial resources or is afraid of the risk of losing, he may not be able to prove his case, or the court may make a mistake. Second, the amount of damages to be paid by the debtor may be less than the creditor's actual losses because the creditor is unable to prove all damages or because there are statutory limitations on damages. Regarding the latter, German law usually provides for full compensation; there are no restrictions, such as the foreseeability rule. However, compensation is only available for economic damages, while non-economic damages are only recoverable in cases of bodily injury or serious violation of personal rights under art. 253 BGB[83]. Thus, liquidated damages can fill the gap between the creditor's expected damages and the debtor's expected losses in the event of non-performance. The larger the gap, the more attractive the penalty clause is for the creditor.

In Germany, it seems less important than in other legal systems that penalty clauses have a deterrent function, since German law usually satisfies the requirement of specific performance. As a consequence, a creditor who wants to make sure that he receives performance usually does not need to resort to a penalty clause. Nevertheless, a penalty clause makes sense if the debtor's obligation is difficult to enforce, namely in the case of service obligations and obligations to refrain from certain acts, such as confidentiality clauses or restraint of trade clauses.

The second function of penalty clauses is to provide compensation to the creditor if the debtor does not behave as required.[84] As discussed above, this is especially important if the creditor suffers non-economic losses or if its losses are difficult to prove.

Turning to the third function-excluding injunctions, penalty clauses serve another purpose in the law against unfair competition. If a company violates the unfair competition law, its competitors and some trade and consumer protection associations can sue that company and obtain injunctive relief if there is a risk that the company will repeat the violation. If the company foresees a fine for future violations, the court will consider that there is no risk of

[83] See footnote 35.

[84] W. Lindacher, *Soergel, Bürgerliches Gesetzbuch mit Einführungsgesetz und Nebengesetzen* (vol. 5/3, 13th edition, Stuttgart: W. Kohlhammer, 2010): 5–7.

future violations and therefore will not grant injunctive relief. Thus, section 12, paragraph 1, clause 1 of the German Act against Unfair Competition (*Gesetz gegen den unlauteren Wettbewerb*, UWG) provides: 'Parties entitled to assert a cessation and desistance claim should warn the debtor prior to initiating court proceedings and should give him the opportunity to resolve the dispute by incurring the obligation to cease and desist subject to a reasonable contractual penalty.'[85]

2.1.2 Penalty clauses and liquidated damages clauses

The first two functions of penalty clauses - deterrence and compensation - are also performed by liquidated damages clauses. Such clauses are primarily designed to compensate the creditor, but they also affect the debtor's incentives to perform. Thus, it is difficult to distinguish between these two types of clauses, but it is impossible to avoid it because German law provides different sets of rules for these two types of clauses. For example, in standard business terms a liquidated damages clause is invalid if the lump sum exceeds the damage expected under normal circumstances or if the other party is not allowed to prove that the actual damage is significantly less than the lump sum according to art. 309, No. 5 BGB for consumer contracts) - both limitations obviously cannot be applied to contractual penalty clauses. On the contrary, the judge has the right to reduce the amount of penalty, but has no right to reduce the amount of the specified liquidated damages. If the reservation is primarily intended to put pressure on the debtor to perform the obligation, it must be construed as a penalty clause. On the other hand, if its function is to help the creditor sue for damages, it should be construed as a liquidated damages clause. An important factor is how the amount to be paid is calculated.

If the parties intend to set the amount at the amount of the creditor's expected loss, it is a liquidated damages clause; if they intend to set it otherwise, especially if they set a higher amount, it is a penalty clause. An indication can be derived from the wording of the clause. The use of words such as "damages," " loss," or "loss of profits" indicates a liquidated damages clause.[86]

[85] "Act against Unfair Competition", translate version, accessed 20 November 2022, https://www.gesetze-im-internet.de/englisch_uwg/englisch_uwg.html .

[86] See footnote 83.

Penalty clauses must be agreed to in the contract between the debtor and the creditor. The debtor cannot unilaterally stipulate a penalty, nor can a court award a penalty. Thus, penalties under German law are completely different from punitive damages.

Penalty clauses are considered conditional promises. The debtor promises to provide performance if he does not act in accordance with the plan.

2.1.3 Limitations on penalty clauses

Speaking of the invalidity of a secured obligation, a debtor should not be compelled to act in a certain way by a penalty clause if the law declares the obligation to behave in this way invalid. Thus, under a dependent penalty clause, no penalty can be assessed if the law declares the secured obligation to be invalid. An independent penalty clause is invalid under § 344 BGB if the obligation with respect to the debtor's conduct giving rise to the penalty is invalid. For example, if the obligation is invalid according to the Statute of Frauds (Art. 125 para. 1 BGB) or because it is contrary to law (Art. 134 BGB) or public policy (Art. 138 BGB), the penalty clause is invalid. In particular, penalty clauses are invalid if they severely restrict the debtor's freedom to exercise his fundamental rights, e.g. penalty clauses to marry (Art. 1297 para. 2 BGB), to refuse divorce or to withdraw from an association according to art. 9 para. 3 para. 2 German Constitution [87].

According to Art. 138 BGB the penalty clause contrary to public policy, even if the secured obligation is valid, the penalty clause may be invalidated as contrary to public policy. In particular, it may be held invalid if the penalty is excessive in relation to the act for which it is provided for. For example, the Dusseldorf Court of Appeal had to decide the issue of a penalty clause in a contract between a landlord and a brewery. The landlord had promised to purchase all drinks to be served in his restaurant from this brewery and to pay €2,500 for each breach of that promise.[88] One might argue that paying €2,500 for buying one bottle of beer elsewhere is too much.[89] On the other hand, one must consider that it is quite unlikely that the brewery

[87] "German Constitution", translated version, accessed 20 November 2022, https://www.gesetze-im-internet.de/englisch_gg/ .

[88] *Neue Zeitschrift für Miet- und Wohnungsrecht* (Publlishing Chbeck, 2008): 611.

[89] Rieble, supra note, 81: 339.

would discover the breach and demand a penalty. Therefore, a high fine seems justified in order to make the landlord refrain from violating his obligations.

In some cases, the law protects the debtor by expressly declaring liquidated damages provisions invalid. For example, a tenant in an apartment may not promise to forfeit to his landlord (Art. 555 BGB) and a trainee may not promise to forfeit to his employer under art. 12, para. 2, no. 2 of the Vocational Education Act (Berufsbildungsgesetz, BBiG)[90].

2.1.4 Penalty clauses in standard business terms

If penalty clauses are contained in standard commercial terms and conditions, as is often the case, stricter restrictions apply. In Germany, standard commercial clauses are subject to judicial review not only in consumer contracts, but also in the B2B context, although the standards for review are somewhat different under Article 310 BGB. In consumer contracts, a clause is invalid if it provides for a penalty in case of non-acceptance or untimely acceptance of performance by the merchant or in case of late payment under art. 309, No. 6 BGB; such penalty provisions are only valid if they are stipulated individually. Other penalty clauses shall only be subject to the general rule that standard commercial terms and conditions shall be invalid if, contrary to the requirement of good faith, they unreasonably put the other party at a disadvantage under Art. 307 BGB. For example, a penalty clause securing the obligation of the consumer to immediately register the change of ownership of a used car has been found to be valid. In contracts between businessmen, there are no special restrictions for penalty clauses contained in standard business terms. Only the general rule applies according to art. 307 BGB. For example, the German Supreme Court has ruled that provisions stipulating the payment of a penalty for each day of default are only valid if they set a maximum amount.

While the validity of a penalty clause must be evaluated from the moment the parties agreed on the penalty clause, art. 343 BGB allows for a review of the amount of the penalty from the moment it is due. The debtor may ask the court to reduce the penalty to a reasonable amount if it is unreasonably high. In determining whether the penalty is unreasonable, the court must consider the situation not at the time the penalty is agreed upon, but at the time it occurs. Thus, section 343 BGB allows the court to control the application of valid penalty provisions. The

[90] "The Vocational Education Act", translate version, accessed 20 November 2022, http://www.gesetze-im-internet.de/bbig_2005/index.html .

court must consider all of the circumstances of the particular case. Section 343, paragraph 2 of the BGB refers to ”every legitimate interest of the creditor, whether pecuniary or not.”[91] Other factors include the severity of the breach, the degree of fault, the danger to which the creditor was exposed because of the breach, and the risk of further breaches. If the breach was willful, a reduction of the penalty is generally not appropriate.[92]Section 343 BGB does not apply if the debtor is a merchant according to article 348 of the German Commercial Code (Handelsgesetzbuch, HGB)[93]. This places a serious burden on merchants, since they are only protected if the penalty clause is invalid, but not if specific cases make its application disproportionate. Most authors agree that in extreme cases a creditor may be denied a claim for penalty on the basis of the principle of good faith under Article 242 BGB.[94] The Supreme Court considered such a case against a defendant who agreed to pay a penalty of €7,500 for each violation of an agreement not to produce or sell a certain type of baby cushion. In violation of the agreement, the defendant sold 7,000 pillows, which were still in his warehouse, at a price of €9 each. The plaintiff then demanded a penalty of more than 53 million euros. The Supreme Court ruled that since Article 343 BGB did not apply in favor of the merchants, the court could not reduce the penalty to a reasonable amount, but only to an amount that was not contrary to the principle of good faith. Thus, the Supreme Court allowed the penalty to be reduced to twice the reasonable amount[95]. As a result, the defendant only had to pay €200,000.

In conclusion, penalty clauses are generally recognized in German law. They are only subject to general restrictions on freedom of contract. If a penalty clause is part of standard commercial terms and conditions, it is subject to more judicial scrutiny in both B2C and B2B transactions: It is invalid if, contrary to the requirement of good faith, it unreasonably disadvantages the debtor. The peculiarity of penalty clauses is that the court considers not only the validity of the clause, but also how it works in a given case: If, given all the facts of the particular case, the penalty clause is unreasonably high, the court may reduce it to a reasonable amount. However,

[91] See footnote 35.

[92] See footnote 83.

[93] ”The German Commercial Code”, translate version, accessed 20 November 2022, https://www.gesetze-im-internet.de/englisch_hgb/ .

[94] Lindacher, supra note, 83: 343.

[95] ”BGH I ZR 168/05 (2008)”. Accessed 20 November 2022 , http://juris.bundesgerichtshof.de/cgi-bin/rechtsprechung/document.py?Gericht=bgh&Art=en&az=I%20ZR%20168/05 .

this rule does not apply if the debtor is a merchant. In that case, the court may interfere with the penalty clause only in extreme cases, guided by the principle of good faith.

Penalty clauses must be clearly distinguished from liquidated damages clauses, on the one hand, and from guarantees, on the other. Of course, this distinction raises difficult drafting issues. But these problems are unavoidable so long as the law does not make all types of reservations subject to the same rules. It would make no sense to treat them all the same way because they have different functions and bear different risks for the debtor.

A guarantee seems to be the riskiest for the debtor because he must pay no matter what event gives rise to rights under the guarantee, especially regardless of his guilt. In addition, there is no special judicial control for guarantees; in particular, the court cannot reduce the amount the debtor must pay. However, the debtor who assumes the guarantee is usually aware of the risk he bears - it is common knowledge that guarantees impose a great risk on the guarantor. Consequently, the German legislator sees no need for special protection of guarantors, for example by imposing a form requirement.[96] On the contrary, a debtor who subjects himself to a penalty clause usually believes that he will fulfill his obligations and, as a consequence, the penalty will never accrue. Therefore, he is likely to inadequately weigh the advantages and disadvantages he gains from accepting the penalty clause. Thus, the law protects him both by requiring fault and by making the application of the penalty clause subject to judicial review. Indeed, it would be inconsistent to require - as German law does - the fault of the debtor for the simple obligation to compensate the creditor for the loss the debtor has suffered as a result of the debtor's breach, but not to require his fault for the obligation to pay penalty, which usually exceeds the creditor's loss.

A liquidated damages clause should be distinguished from a penalty clause because the standard of judicial review must necessarily be different. The purpose of a liquidated damages clause is to simplify proceedings after a breach, not to impose a penalty on the breaching party. Consequently, it is necessary to examine whether the amount set by the parties is a reasonable estimate of the creditor's loss in the event of a breach. A penalty clause, by contrast, is designed to induce the debtor to perform by imposing a more onerous burden in the event of a breach than simply compensating the creditor for the creditor's loss. For this reason, the amount of the

[96] N. Horn, *J. von Staudingers Kommentar zum Bürgerlichen Gesetzbuch mit Einführungsgesetz und Nebengesetzen – Bürgschaft* (Berlin: Sellier/de Gruyter, 2013): 765.

creditor's loss may be only one factor in considering penalty. Even a penalties significantly in excess of those losses may be upheld.

2.2 Contractual Penalties in French Law

In France, contractual penalties are a rather classic topic of discussion. These discussions mainly focus on two issues: and its limitations on the one side of contract on the other freedom. Moreover, the vague distinction between liquidated damages and contractual clauses in French law raises further questions. In legal practice, the use of contractual penalties is widespread because they reduce the uncertainty associated with judicial assessment of damages. Although the ”contractual term unfairness” approach is currently limited to consumer-to-consumer contracts, it may in the future be extended to commercial-to-business contracts, thus greatly limiting the debate around the classification of contractual clauses as penalties.

2.2.1 Definitions and provisions in the law

Article 1152 of the French Civil Code specifies unsettled losses, which are included in the section ”Of Damages Resulting from the Non-Performance of an Obligation.” According to this article, ”Where an agreement provides that he who fails to perform it will pay a certain sum as damages, the other party may not be awarded a greater or lesser sum”[97] . But this provision was included in the very first edition of the Civil Code in 1804. However, much later, in 1975, a second paragraph was added to article 1152, which stated that ”the judge may, even of his own motion, moderate or increase the agreed penalty, where it is obviously excessive or ridiculously low”[98]. It goes on to say that ”any stipulation to the contrary shall be deemed unwritten» . The second paragraph of article 1152 of the Civil Code creates the first uncertainty regarding the classification of the reservation in question: the first paragraph refers to the classic damages clause, while the second paragraph relies on a formulation that is more related to the field of contractual penalties.

[97] See footnote 34.

[98] Ibid.

It is also worth noting the second set of provisions of the Civil Code. Indeed, Articles 1226-1233, which are included under ”Of Obligations with Penalty Clauses” provide a more detailed legal basis for said penalty clauses. According to Article 1226, ”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.” The coercive function of penalty is quite evident in this provision. It should also be noted that the penalty is compensation for the damage that the creditor has suffered as a result of the failure to perform the main obligation.[99] Interestingly, the courts do not require the creditor to prove actual damages.[100] Thus, nonperformance is a distinguishing criterion among contractual clauses: If the payment of the stipulated amount is not caused by the debtor's default, classification as a contractual penalty should be excluded. Some contractual clauses provide for the payment of an amount after one of the parties has exercised the right granted to it under the contract. This is often the case, for example, in preliminary contracts for the sale of real estate, in which a deposit or ”reservation fee” is very often paid, which is lost when the eventual buyer relinquishes his right to enter into a final contract of sale. This also, of course, applies to forfeiture provisions, often used in contracts of sale, and to indemnification under non-compete provisions. The indemnity is not for noncompetition, but as compensation for the obligation not to compete, which is a waiver. These various amounts cannot be considered penalties because they do not relate to the default.[101]

It also follows from this that in case of partial fulfillment of the obligation, the agreed fine may be reduced by the judge, even on his/her own initiative, in proportion to the interest that the fulfilled part provided to the creditor.[102] Further, the accessory nature of contractual penalty is enshrined in Article 1227: ”Nullity of the principal obligation involves that of the penalty clause. ”[103]

Moreover, the enforcement of contractual penalties is not an obligation for the creditor and represents an auxiliary possibility for him/her, in the sense that he/she, ”instead of claiming the penalty stipulated against the debtor who is under notice of default, may proceed with the

[99] Ibid.

[100] P. Jourdain and G. Viney, *Les Effets de la Responsabilité*, (LGDJ, 2011): 239.

[101] L. Usunier, *Revue des contrats* (LGDJ,2014): 520.

[102] See footnote 34.

[103] Ibid.

performance of the principal obligation".[104] The clause, in any case, is not enforceable in case of fraud or gross negligence of the creditor and only occurs when the debtor is under notice of default.[105]

According to the aforementioned provisions, the primary function of a contractual penalty is coercive and/or deterrent. This should distinguish contractual penalties from liquidated damages clauses, in which the compensatory function prevails, since they fix in advance the amount of damages in case of non-performance of the obligation. Thus, if the stipulated amount exceeds the actual loss, the penalty aspect prevails. There are cases where, on the contrary, the stipulated damages are inferior to the actual damages. In these cases, the effect of the reservation is to limit liability. However, such a clause should not be regarded as a penalty if it has no coercive function.

2.2.2 Practical application

The number of contracts in which contractual penalties are included is quite significant. This is probably due to the fact that penalty clauses bring legal certainty to contractual agreements and prevent difficulties in the judicial evaluation of damages, as well as prevent non-performance due to their deterrent effect.[106] Traditional examples concern contracts of sale, service contracts, real estate construction contracts, loan contracts, transport contracts and so on.[107] Penalty clauses can be associated with various obligations: quality, performance, obligations to do The stipulated non-performance can be total or only partial, even including delayed performance.[108]

Recent examples relate to preliminary contracts for the sale of real estate, in which failure to apply for credit in accordance with the terms set out in the preliminary contract triggers the

[104] Ibid.

[105] Ibid.

[106] P. Jourdain and G. Viney, supra note, 99: 230.

[107] Ibid.

[108] Ibid.

payment of liquidated damages.[109] In contrast, in the same legal field, if credit is not granted regardless of any breach of obligation by the debtor, the payment of a penalty cannot be demanded by the creditor.[110] Contracts of employment also often specify contractual penalties.[111] The classification of a provision as a penalty also applies when the payment of a certain amount in the event of breach is based on a collective agreement provision.[112]

Jurisdictions tend to regard these various provisions, under Article 1152 on the one hand, and under Articles 1226 et seq. on the other, as belonging to ”penalty clauses”.[113] This has the practical and important consequence of giving all these clauses a general power of review by a judge, under the second paragraph of Article 1152 and Article 1231. More precisely, the French Cour of Cassation is inclined to include two types of clauses: liquidated damages and contractual penalties, within the scope of the provisions on contractual penalties. This approach is in line with the intent of the legislator, who in 1975, when introducing the right of judicial review, included these two sets of provisions in the scope of the reform.[114] In practice, most examples of judicial review of contractual penalties are based on Article 1152 of the Code Civil.

Therefore, the preliminary question of the classification of a contractual condition as a condition on liquidated damages or as a condition on forfeiture is very relevant. This assessment by arbitral tribunals must be carried out strictly. The relevant criterion is the level of the agreed amount of damages and the fact that the penalty is charged in case of default.[115] The judge does not need to establish real damages or assess their amount.

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[109] ”*Cour de Cassation,* 3rd Civil Chamber, 12-29021, 2013”, accessed 20 November 2022, https://www.legifrance.gouv.fr/juri/id/JURITEXT000028230208 .

[110] ”*Cour de Cassation*, 3rd Civil Chamber, 12-27182, 2014”, accessed 20 November 2022, https://www.legifrance.gouv.fr/juri/id/JURITEXT000028604210/ .

[111] ”*Cour de Cassation,* Social Chamber, no. 06-45316, 2008”, accessed 20 November 2022, https://www.legifrance.gouv.fr/juri/id/JURITEXT000017876042/ .

[112] M.Caron, ”Nouveautés et constances de la clause pénale”, *Cahiers Sociaux* 265 *(*2014): 455.

[113] P. Jourdain and G. Viney, supra note, 99: 229.

[114] Ibid.

[115] ”*Cour de Cassation,* 3rd Civil Chamber, no. 07-12848, 2008”, accessed 20 November 2022, https://www.legifrance.gouv.fr/juri/id/JURITEXT000018869007 .

The legal regime of contractual penalties departs intensely from the usual rules of contract law, giving the judge the power to modify the content of the obligations. Despite the assertion of the first paragraph of Article 1152 of the Civil Code that contracts are intangible,[116] the second paragraph of the same article departs from this intangibility. The judge does have the right, even on his own initiative, to moderate or increase the agreed upon penalty if it is manifestly excessive or ridiculously low. The parties cannot exclude the judge's right of review. This right of review does not mean that the judge must assess actual damages. In fact, the judge is precluded from assessing loss and must focus on the excessive or ridiculously low level of agreed upon penalty.[117] Clearly, this rule is more of a theoretical obligation imposed on the judge to preserve the classification of the contract term as a contractual penalty and, therefore, to honor the parties' intent. If the judge had the power to reduce or bring the agreed upon amount down to the amount of actual damages, it would violate the parties' intent in entering into the contract.

A reduction in excess of the agreed penalty should not result in a mere award of damages corresponding to actual loss. At the same time, however, a judge may not reduce the amount of damages below the actual loss. This would be contrary to the intent of the parties and would also call into question the classification of the contractual condition as a contractual penalty. In such a situation, the ”coercive” function of a penalty would essentially be abrogated, and the effect of the clause would be rather to limit the debtor's liability. Therefore, the judge must preserve the purpose of the contractual penalty, which is the intention of the parties: Perhaps the parties wanted to give an advantage to the debtor, when the agreed amount is excessively low or to give an advantage to the creditor, when the agreed amount exceeds the actual damages. Needless to say, a judge may also find that the clause was imposed by the stronger party and that it is an unfair condition to be avoided.

The judge's right to reduce or increase the amount of contractual penalty is quite discretionary in the sense that he/she is not required to justify his/her refusal to reduce the stipulated amount. In other words, keeping the amount the same simply means enforcing the contractual penalty. The judge is not required to justify the enforcement of what the parties desired. The excess is assessed at the time of adjudication. An insignificant excess is not sufficient to trigger the judge's power of deterrence. On the contrary, an objectively excessive amount almost

[116] See footnote 34.

[117] M. Fabre-Magnan, *Droit des obligations* (Paris: Presses Universitaires de France - P.U.F.,2021): 669–670.

automatically leads to a reduction.[118] Neither the debtor's conduct nor his/her financial situation should theoretically be taken into account to assess the excess of the agreed amount. The objective reason for changing the amount is the excess or low level of the stipulated penalty.

2.2.3 Specific Legal Areas and Regulations

General contract law and consumer law often collide in the area of contract terms. Contractual penalties are no exception. Indeed, under Art. R. 132-2, third paragraph, the provision ”requiring any consumer who fails to fulfill his/her obligation to pay a disproportionate high sum in compensation” is considered unfair.[119] The definition of this provision is very similar, if not identical, to the test set forth in section 1152, second paragraph, on the power of judicial review of contractual penalties. One may therefore wonder why a consumer should rely on this particular provision of the Code de la Consommation. There are several reasons for this. First, said article provides a presumption of unfairness, relieving the consumer of the burden of proving it. Secondly, this sanction may be considered more effective, since the unfair condition will be deemed unscripted, not only reduced in amount. Recall also that the consumer is not precluded from proving an unfair condition, even if the amount to be paid is not disproportionate. In this case, the condition will also be considered as unwritten.[120]

Similarly, the Commercial Code in Art. L. 442-6, I, 2 provides for the liability of a producer, trader or any business person who has imposed or attempted to impose on a commercial partner obligations which cause a significant imbalance in the rights and obligations of the parties arising from the contract. A penalty clause imposing a grossly excessive amount payable is likely to be regarded as causing a significant imbalance in the rights and obligations of the parties and, therefore, may result, in addition to judicial review, in liability to the creditor if the condition is satisfied.

[118] P. Jourdain and G. Viney, supra note, 99: 253.

[119] ”Code de la consommation”, LegiFrance, accessed 20 November 2022, https://www.legifrance.gouv.fr/codes/article_lc/LEGIARTI000006292911 .

[120] See footnote 100.

In another legal area relating to residential leases, Article 4(i) of Act No. 89-462 states that a condition that gives a landlord the right to collect a fine or penalty in the event of a breach of lease is considered unfair.[121]

The use of contractual penalties is also limited in specific legal areas. For example, under Articles L. 311-30 and L. 312-22 of *the Code de la Consommation*:

> *in the event of default by the borrower, the lender may ask for immediate repayment of the capital outstanding, plus interest accrued due but not paid. Until the actual settlement date, the outstanding sums are liable to interest on arrears at the same rate as the loan. In addition, the lender may ask the defaulting borrower for compensation which, depending on the length of contract still left to run and without prejudice to the application of Articles 1152 and 1231 of the French civil code, shall be fixed in accordance with a scale fixed by decree.*[122]

This means that for consumer loans there is a statutory limit on the amount of contractual penalty. Article L. 312-22 of *the Code de la Consommation* relies on the same instrument of legislative scale limiting the amount as article L.113-10 of *the Code des Assurances*, according to which the penalty for error or omission in statements made by the insured party cannot exceed 50% of the missed premium.

In contrast, statutes sometimes set thresholds for parties. Under Art. R. 231-14 *Code de la Construction et de l'habitation*, if there is a delay in completing a home, the penalty cannot be less than 1/3000 of the value of the home for each day of delay.

2.3 Penalty Clauses in Italian Law

Italian law does not distinguish between penalty clauses and liquidated damages. The Italian Civil Code contains only one regime for a clause on penalties (*clausola penale*), according to which the agreed amounts may be reduced by a judge if they are manifestly excessive, regardless of the intention of the contracting parties (Art. 1384 of the Italian Civil Code).[123]

[121] P. Jourdain and G. Viney, supra note, 99: 234.

[122] See footnote 34, Emphasis added.

[123] F.P. Patti, ”Penalty Clauses in Italian Law”, *European Review of Private Law* 3(2015): 317–322.

Furthermore, the Italian Consumer Code[124] stipulates that a clause requiring a consumer who fails to perform or delays in performing his obligation to pay a manifestly excessive amount of money in the form of compensation, penalty or the like is considered unfair (art. 33, para. 2, letter f) and therefore void, while the rest of the contract remains valid (art. 36).

The main focus of this chapter will be on the historical overview and definition of contractual penalties under Italian law, the clarification of the Italian Supreme Court regarding the reduction e*x officio*, as well as on penalty clauses in the context of private law sanctions and in consumer contracts.

The Italian rules on penalty clauses are a typical expression of the continental model adopted in many civil law jurisdictions, which do not distinguish between penalty clauses and liquidated damages clauses.[125] Regardless of the intention of the contracting parties, the Italian system provides only one regime, consisting of default and mandatory rules.

In the first *Codice civile* of 1865, the provisions relating to penalty clauses were based on the provisions of the *French Code Civil*. The articles on penalty clauses were basically a translation of the French provisions *of clause pénale*. According to article 1212 of the 1865 *Codice civile*, the penalty clause was ”the compensation of losses suffered by the creditor for non-performance of the main obligation.” As in the French codification, contract law was based on the principle of freedom of contract; like any other contractual agreement, the penalty clause was subject to the peremptory rule ”*les conventions légalement formées tiennent lieu de loi à ceux qui les ont faites*” according to article 1134 of the *Code civil*. Penalty clauses are no different from any other contractual clauses. There is no special mechanism to protect the debtor in the case of an obligation to pay a very large sum.

Many novations, this time inspired by the German legal systems:Germany, Austria and Switzerland, were introduced with the Codice civile of 1942. During this period it became clear that due to the economic pressure on the debtor's main obligation, the penalty clause was not an agreement similar to other agreements. Therefore, the legislator introduced the power of the judge to reduce the amount of penalty in case of manifest excessiveness or in case of partial

[124] ”The Italian Consumer Code”, accessed 20 November 2022, https://www.codicedelconsumo.it/english-version/ .

[125] I. Marin Garcia, ”Enforcement of Penalty Clauses in Civil and Common Law: A Puzzle to be Solved by the Contracting Parties”, *European Journal of Legal Studies* 5,1 (2012) : 98–123.

performance of a contractual obligation under Article 1384 of the Codice civile[126]. There is also a new definition that focuses on the effects of the penalty clause: Article 1382 *Codice Civile* provides that a clause whereby, in the event of default or untimely performance of an obligation, one of the parties must provide a certain penalty has the effect of limiting compensation to the specified penalty, unless compensation for additional damages has been agreed upon. The penalty is owed to the creditor regardless of the evidence of harm. From a systemic point of view, the rules of the penalty clause are in the general part of contract law and not, as in the international uniform projects, in the special field of contract damages.

Another aspect affecting the provision of the law on penalties is the existence of the principle of good faith and fair transactions in the new Civil Code. Along with the principle of solidarity stipulated in article 2 of the 1948 Constitution of Italy, in recent years the interpretation of the principle of good faith and honest relations has led to numerous changes in Italian contract law. Currently, judges use the general principle to resolve cases where strict application of the law would lead to unfair results. The growing importance of the principles of solidarity, good faith and honest relations has led to an innovative interpretation of some rules concerning penalty clauses with respect to the authority to control the agreed amount.

New rules on penalty clauses have been introduced with the implementation in the Italian legal system of Directive 93/13/EC on 'Unfair Terms in Consumer Contracts[127]'. According to Letter (e) of the Annex, the term that has the object or effect of 'requiring any consumer who fails to fulfil his obligation to pay a disproportionately high sum in compensation' may be regarded as unfair. This provision, introduced in the Consumer` Code, is a further restriction on freedom of contract.

In Italian law, there are no special rules concerning penalty clauses in standard form contracts. The protection of the non-defaulting party is provided by the fact that the judge has the right to reduce the amount of the penalty.

Under Italian law, in contrast to common law, provisions that are not a prior estimate of damages are enforceable. The parties to a contract are free to fix the amount payable for default.

[126] See footnote 36.

[127] See footnote 40.

This freedom may lead to abuse in cases where there is a gross disproportion between the amount set as penalty and the actual loss incurred by the creditor.

Article 1384 of the Codice civile provides for the right of the judge to reduce the amount of the penalty if it is clearly excessive or in the case of partial performance of a contractual obligation. This rule is mandatory, and any agreement that excludes the right to reduce the penalty is invalid.[128] Reducing the amount is a matter of the judge's discretion.

The reasons underlying the judicial power to reduce the amount stipulated in the penalty provisions have varied over time. In the beginning, the control was against usury and cases of unjust enrichment. Nowadays, the underlying reasons are to be found in the duty of good faith and in the general interest, which has a constitutional basis in Article 2 of the Italian Constitution[129], to limit the autonomy of the parties within certain limits, so that the exercise of this autonomy does not turn into an abuse of the principle of freedom and equality of parties.

2.3.1 The Function

From a practical point of view, the functions of penal clauses are obvious: saving litigation costs, inducing performance, encouraging the contractual parties to settle before the trial, and others.

From a theoretical point of view, the debate on penal clauses in the Italian literature has concerned the more general topic of private law sanctions (*pene private, peines privées, Privatstrafen*). Since the 1980s, new studies on penal clauses related to the topic of private law sanctions have been published.[130] The renewed interest of Italian scholars in private law sanctions was mainly due to some changes that affected the legal landscape on the continent. However, looking back on this period, one can see that the interest related to private law sanctions was actually focused on other areas of private law.

[128] C.M. Bianca, *Diritto Civile V - La Responsabilità* (vol.5, Milan: Giuffrè, 2020): 256.

[129] "The Italian Constitution", accessed 20 November 2022, http://www.prefettura.it/FILES/AllegatiPag/1187/Costituzione_ENG.pdf

[130] E. Moscati, "Pena privata e autonomia privata", *Rivista di diritto civile* I (1985) :511–543.

In Italy at the beginning of the 1960s there was a great interest in this subject[131] , and at the beginning of this century the first publications on the subject appeared at European level.[132]

The problem of recognition and enforcement of US judgments on the subject of punitive damages in continental Europe is another important issue concerning private law sanctions. This specific aspect of the American law of damages has been extensively studied in the Italian legal literature.[133]

The growing interest in the concept of private sanctions has also been driven by more general interests, such as the protection of the environment. Therefore, the concept of private law sanctions was often taken out of the realm of contract law and related to the problem of an insufficiently broad scope of recoverable damages. In many situations, the ordinary law of damages was insufficient to protect the relevant interests.

Returning to the original topic we are dealing with, the liquidated damages clause was not an innovation in the context of private law sanctions. The agreed remedy was already present in the Code civil, in the Italian codifications and in the BGB. Originally, the penalty clause was considered in works on private law sanctions only as an example demonstrating the reconstruction of the punitive function of private law. It would not be correct to say that, over the last century, it was the penal clause that has been the main contributor to the growth of interest in private law sanctions.

In Europe, the interpretation of the penalty clause as a private law sanction is not common to all legal systems. For example, according to the German doctrine, which has perhaps dealt more deeply with the controversial issue, a penalty clause, despite its seemingly punitive nature, is not considered a private law sanction because it is the result of a contractual agreement.[134] In this respect, the concept of private law sanctions will only relate to obligations that have their source in the law. From this point of view, an obligation to which a contracting party has voluntarily submitted cannot be a civil law sanction.

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[131] A. Cataudella, *La tutela civile della vita privata* (Milano: Giuffrè, 1972): 65 .

[132] L. Hugueney, *L'ideé de peine privée en droit contemporain* (Paris: A. Rousseau, 1904): 225.

[133] P. Cendon, *Il dolo nella responsabilità extracontrattuale* (Torino: Giappichelli, 1974): 87.

[134] W.F. Lindacher, *Vertragsstrafe, Schadensersatzpauschalierung und schlichter Schadensbeweisvertrag* (Frankfurt am Main: Athenäum, 1972): 63.

There are different points of view: some argue that the reservation has a punitive function,[135] others a compensatory function,[136] others a dual function, both coercive and compensatory.[137] For the moment, according to the prevailing opinion in the Italian literature, liquidated damages reservations may have different functions.[138]

Italian law recognizes only one concept of an agreed amount for non-performance, called a penalty clause, but the function of this clause reflects the different intentions of the contracting parties depending on the different types of contracts in which the penalty clause is included.

Also, various decisions of the Italian Supreme Court (*Corte suprema di cassazione)* contain some important findings on the function of the penalties.

In a famous 2007 case[139] concerning the recognition of American punitive damages in Italy, the Italian Supreme Court addressed the problem of the function of penalty clauses. In the first instance, the Venetian Court of Appeals confirmed that punitive damages are contrary to Italian public policy. The Supreme Court also rejected the claim, stating that "the current legal system, the idea of punishment is alien to any award of civil damages. The wrongdoer's conduct is also considered irrelevant. The task of civil damages is to make the injured party whole by means of an award of a sum of money, which tends to eliminate the consequences of the harm done."[140]

An interesting point is that appellant's main argument in proving that the Court of Appeals was wrong in holding that the award of punitive damages was contrary to domestic public policy was that the Italian legal system recognizes various remedies that pursue punitive purposes. The most problematic example that was used was the penalty clause.

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[135] V.M. Trimarchi, *La clausola penale* (Milano: Giuffrè, 1954): 49.

[136] Bianca, supra note, 127: 246.

[137] G. Barassi, *La teoria generale delle obbligazioni*, vol. III (Milano: Giuffrè, 1948): 480.

[138] G. Gorla, *Il contratto. Problemi fondamentali trattati con il metodo comparativo e casistico*, vol. I, *Lineamenti generali* (Milano: Giuffrè, 1955): 240.

[139] "Cassazione civile sez. III, 1183(2007)", accessed 20 November 2022, https://elearning.unite.it/pluginfile.php/173635/mod_resource/content/0/Cass.1183-2007%20No%20danni%20punitivi.pdf .

[140] F. Quarta, *Hastings Int'l & Comp. L. Rev.* 31,1 (2008): 753,782.

According to the Italian Supreme Court, penalty clauses have no punitive purpose. The penalty clause serves to strengthen contractual relations and to quantify damages in advance, so that if its granting entails, in the judge's discretion, an abuse of the parties' freedom of contract, contrary to the principle of proportionality, it may be reduced by the judge.

Thus, despite the fact that the penalty clause amount agreed upon is owed to the offending party without proof of the damages suffered, in the opinion of the court, penalty clauses cannot be compared to punitive damages typical of Anglo-American law; an institution which is not only related to the offender's conduct rather than to the type of harm caused, but is characterized by an unjustified disproportion between the damages awarded and the harm actually incurred.

Obviously, the decision of the Supreme Court was motivated by political considerations: the purpose was to exclude punitive damages from the Italian legal system. In some cases where the recipient of the penalty does not suffer any loss, as the doctrine asserts, the function of the penalty can certainly be punitive, even if the amount agreed upon can be reduced, such as in employment contracts or in the statutes of associations or companies. In any case, this decision reflects a factual trend in Italian case law, assigning a compensatory function to penalties.

2.3.2 Penalty Clauses in Consumer Contracts

In business-to-business and consumer-to-consumer relationships, a penalty clause can lead to a significant imbalance of rights and obligations in the event of default. After all, it is well known that sellers and suppliers have a considerable advantage by defining terms in advance, and as a rule, consumers do not focus their attention on ancillary clauses such as the penalty clause. In this respect, the rules that enacted Directive 93/13/EC are part of the Italian Consumers` Code.

According to Article 33(1) of the Italian Consumer Code, in contracts entered into between consumers and professionals, conditions are considered unfair if, contrary to good faith, they cause a significant imbalance in the rights and obligations arising under the contract to the detriment of the consumer. Regarding penalty clauses, Article 33(2) letter f) states that a condition obliging any consumer who fails or delays in performing his obligation to pay a clearly excessive amount of money in compensation, penalty clause or the like is considered

unfair.[141] Under Article 36 of the Consumer Code, a condition considered unfair is invalid, while the rest of the contract remains valid.

The criterion for assessing whether a sum of money is manifestly excessive is not the same as that of Article 1384 of the Codice civile. The judge must also take into account the relative weakness of the consumer in relation to the other party to the contract and the fact that this condition can be used as a standard condition in a multitude of contractual relationships.[142]The rule set forth in Article 33(2)(f) is also considered applicable to deposits and forfeiture provisions.[143]

The important decision of the European Court of Justice,[144] according to which 'Article 6(1) of Directive 93/13 must be interpreted as meaning that it does not allow the national court, in the case where it has established that a penalty clause in a contract concluded between a seller or supplier and a consumer is unfair, merely, as it is authorized by national law, to reduce the amount of the penalty imposed on the consumer by that clause, but requires it to exclude the application of that clause in its entirety with regard to the consumer' will not affect Italian law - by virtue of Articles 33(2) letter f) and 36, in case of an obligation to pay a manifestly excessive amount of money, the penalty clause is null and void.

In contrast, Article 1384 of the Civil Code, which grants the right to reduce the amount of the penalty if it is clearly excessive, does not apply to consumer contracts.

For historical reasons, there is no direct connection between the idea of penalty and the idea of damages in Italian law on contractual penalties. In recent decisions of the Italian Supreme Court, the general duty of good faith and fair dealing has prompted judges to assess the amount of penalty at the time of performance rather than at the time of contract formation. Even if the court did not use the principle of just compensation , this new approach may have the effect of giving the clause a compensatory function. The damages incurred represent a major factor in determining whether, at the time of enforcement, the amount agreed upon is manifestly

[141] See footnote 123.

[142] F. Agnino, *Clausola penale e tutela del consumatore* (Milano: Giuffrè, 2007): 180–186.

[143] G. De Nova, *Le clausole vessatorie* (Milano: Ipsoa, 1996), p 21.

[144] "Dirk Frederik Asbeek Brusse and Katarina de Man Garabito v Jahani BV.,C-488/11(2013) ", Eur-Lex, accessed 20 November 2022, https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A62011CJ0488 .

excessive. The agreed remedy is affected by the duty of good faith: it is considered to be contrary to the requirements of good faith to demand a manifestly excessive amount.

In conclusion, at this stage, penalties in Italian civil law are very different from the common law.[145] Emphasizing the importance of the general duty of good faith and fair dealing may result in the reservation being given a compensatory function. Notwithstanding this, all other circumstances must be taken into account in determining the amount of the penalty.

The adoption of this interpretation would in the long run harmonize Italian law with the DCFR[146], the Principles of European Contract Law (PECL)[147] and the International Institute for the Unification of Private Law (UNIDROIT) Principles[148], where the rules concerning ”agreed” or ” stipulated” payments for defaults provide that the amount specified in the contract may be reduced to a reasonable amount if it is excessive in relation to the damages caused by the default and other circumstances. The mentioned soft law may also inspire Italian law and Italian case law concerning the law on deposits forfeited in case of default. In fact, these provisions are considered applicable also to sums that have been paid in advance.

2.4 Penalty Clauses in English Law

The UK Supreme Court's decision in the Makdessi case marks an important turning point with regard to penalty clauses in England and Wales. The Court considered the leading case of *Dunlop Pneumatic Tyre Co Ltd v. New Garage and Motor Co Ltd*,[149] and in its important decision analyzed the distinction between valid contract clauses, which determine, for example, damages payable upon breach of contract, and invalid penalty clauses, which are contrary to

[145] A. RUSSO, *Inadempimento e clausola penale tra civil law e common law* (Napoli: Jovene, 2012): 63–176.

[146] ”Draft Common Frame of Reference”,PDF, accessed 20 November 2022, https://www.law.kuleuven.be/personal/mstorme/2009_02_DCFR_OutlineEdition.pdf .

[147] ”Principles of European Contract Law”, Trans-Lex, accessed 20 November 2022, https://www.trans-lex.org/400200/_/pecl/ .

[148] ”International Institute for the Unification of Private Law (UNIDROIT)”, UNIDROIT, accessed 20 November 2022, https://www.unidroit.org/ .

[149] See footnote 13.

public policy and unenforceable. Specifically, the court has attempted to bring clarity to the previously complex law on this issue and to define its underlying principles.

Judicial regulation of penalty clauses has a long history in British law, going back to the 16th century, but the court also noted that it is not just a feature of common law. In 2015, the question before the UK Supreme Court was not whether it was time to expand the idea of penalty clauses in the interest of public policy, but whether the doctrine should be repealed altogether on the grounds that it was outdated, inconsistent, and unnecessary. Interestingly, this issue has been raised in two cases: the first Makdessi case involving experienced commercial parties, where an agreement was reached after lengthy negotiations in which both sides were represented by experienced commercial lawyers, and the second Beavis case involving a consumer who was charged £85 (about €100) for exceeding the free parking time limit in a local retail parking lot. This was essentially a case about how David and Goliath challenged the validity of provisions they considered punitive. The court was asked whether the provisions in question were unenforceable as punitive, and in the Beavis case, whether the provision in question was unfair by virtue of the Unfair Terms in Consumer Contracts Regulations 1999[150] (which carries forward the EU Unfair Terms Directive).

Cavendish Square Holding v. Makdessi[151] - this case raises three main questions: what is the scope of the damages rule in English law; should this rule be abolished or amended so that it does not apply to commercial transactions in which the parties have equal negotiating powers and act on the basis of qualified legal advice; and, if not, then how this rule applies to the case in question.

The circumstances of the case are related to a complex agreement in which the defendant agreed to sell the plaintiff a controlling stake in an advertising and marketing company founded by him. The agreement provided that for a certain period after the sale, the defendant would not compete with his former business, and if this happened, the plaintiff would have the right to keep the last two installments of the purchase price (paragraph 5.1) and would have received an option to purchase the remaining shares of the defendant at a price that did not include goodwill (paragraph 5.6). The motivation for these conditions was that the buyer would retain

[150] "The Unfair Terms in Consumer Contracts Regulations 1999",UKLegislation, accessed 20 November 2022, https://www.legislation.gov.uk/uksi/1999/2083/contents/made .

[151] " Cavendish Square Holding BV v Talal El Makdessi and ParkingEye Ltd v Beavis UKSC 2013/0280(2015)", Court, accessed 20 November 2022, https://www.supremecourt.uk/cases/uksc-2013-0280.html .

Mr. Makdessi's loyalty as a means of preserving the value of the company's business reputation, which could be lost if he worked elsewhere.

The U.K. Supreme Court recognized that it was time to review the penalty rule, which has been called ”an ancient, haphazardly constructed edifice which has not weathered well.”[152] Nevertheless, he declined to take drastic steps to repeal the rule or to limit its application to noncommercial cases where the parties were not at arm's length and were not equally balanced: ”we do not consider that judicial abolition would be a proper course for this court to take.”[153] Thus, the goal was to provide a more ”realistic” approach to the substance of the breach contract provisions, along with a more ”principled” approach to the interests that could be adequately protected by the parties' agreement.

The Court was critical of Lord Dunedin's ”too literal” interpretation of the earlier leading Dunlop case. In that case, Lord Dunlop articulated four tests that he thought might be useful or even conclusive in interpreting whether a stipulation to pay a stipulated sum was a liquidated damages or a valid liquidated damages clause. These include:

(1) the provision is penal if ” the sum stipulated for is extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have followed from the breach ”

(2) that the provision would be penal if the violation consisted only of failure to pay money, but it involved payment of a larger amount;

(3) that there is a ”presumption (but no more)” that the provision would be penal if it were subject to payment upon the occurrence of a series of events of varying severity; and

(4) that the provision would not be treated as penal only because of the impossibility of accurately estimating the true damages in advance.[154]

The United Kingdom Supreme Court has decided that the question whether a reservation represents a real prior estimate of damages or is a deterrent should not be regarded as decisive.

[152] Ibid.

[153] Ibid.

[154] See footnote 150.

Thus, the true test for a penalty clause can be formulated as follows:

> *whether the impugned provision is a secondary obligation which imposes a detriment on the contract-breaker out of all proportion to any legitimate interest of the innocent party in the enforcement of the primary obligation.*[155]

Lords Mance and Hodge adopted slightly different formulations of the tests, but agreed that the key questions in the future would be whether the clause satisfies legitimate interests and whether enforcement of these interests is ”extravagant, exorbitant, or unconscionable.”[156] Applying this criterion, the court concluded that neither the revision of the price calculation in paragraph 5.1 nor the termination of relations with shareholders in paragraph 5.6, when Mr. Makdessi violated his non-competitive obligations, were criminal. These clothes are included in a carefully negotiated agreement between informed and legally savvy parties at arm's length. The existence of good faith was at the heart of the agreement. It was found that *Cavendish* had a very substantial and legitimate interest in protecting the value of the company's business reputation, and given this legitimate interest, the provisions could not be considered excessive or unconstitutional.

This represents a significant limitation of the courts' ability to intervene, especially when, as in this case, the parties are dealing on an equal footing with an experienced and sophisticated professional lawyer. The basis for this is freedom of contract. According to Lords Neuberger and Sampet: ” In a negotiated contract between properly advised parties of comparable bargaining power, the strong initial presumption must be that the parties themselves are the best judges of what is legitimate in a provision dealing with the consequences of breach.”[157] Lords Neuberger and Sampson were prepared to treat clause 5.1 (which allowed *Cavendish* to withhold the last two payments from the purchase price) as a basic obligation, namely as a price adjustment provision to which the penalty rule does not apply.[158] The U.K. Supreme

[155] Ibid.

[156] Ibid.

[157] Ibid.

[158] Ibid.

Court has argued that courts will be able to identify ”sham” agreements,[159] but, at the very least, new litigation is likely to arise on this issue. This rule also represents an additional limitation on the powers of the courts to intervene, since it does not allow them to verify the fairness of primary obligations. This is fully recognized by the Court; Lords Neuberger and Sampson noted that there is:

> *fundamental difference between a jurisdiction to review the fairness of a contractual obligation and a jurisdiction to regulate the remedy for its breach. Leaving aside challenges going to the reality of consent, such as those based on fraud, duress or undue influence, the courts do not review the fairness of men's bargains either at law or in equity. The penalty rule regulates only the remedies available for breach.*[160]

On the contrary, the facts of the *Beavis case* could not be simpler. Mr. Beavis parked in a real parking lot, where large and noticeable signs stated that parking was free for 2 hours, but a fee of $85 was charged for exceeding this time. The parking lot was managed by the private company *ParkingEye Ltd* on behalf of the owners. Mr. Beavis exceeded the parking time by almost an hour, but refused to pay a fine of 85 pounds, claiming that it was excessive. The fee was charged regardless of the period of excessive parking - so staying in the parking lot for two hours and one minute would technically have resulted in a payment of 85 pounds.

The UK Supreme Court agreed that such a provision was covered by the rule against penalty, but was not a fine in the circumstances. The court considered whether *ParkingEye* had a legitimate defence interest in imposing the parking charge and whether the charge was exorbitant and unconscionable. The court found that the £85 fee had two objects[161]: managing the efficient use of parking spaces for the benefit of retail outlets and the public wanting to park their cars in the parking lot, this was to be accomplished by preventing customers from parking for more than 2 hours; providing a revenue stream that allows *ParkingEye* to cover the costs of operating the scheme and generate revenue from its services, without which those services would not be available.

[159] Ibid.

[160] Ibid.

[161] Ibid.

The Court considered these goals quite reasonable. By applying the legitimate interest test, *ParkingEye* was legitimately interested in charging motorists over the length of their stay, and the fee could not be considered extravagant, unconstitutional, or disproportionate to its interests, given that it was comparable (albeit higher) than the fee charged by local authorities for parking, and given the use of about this particular parking and clear language of the ads.

Mr Beavis also argued that prices were unfair under the Unfair Terms in Consumer Contracts Regulations 1999. The Court did not agree, despite recognizing that the fee may fall within the description of potentially unfair conditions in paragraph 1(e) of Schedule 2.21. n circumstances where the signs clearly indicated a two-hour period and it was reasonable to expect that the defendant would comply with any violation of the rights of the parties. it did not arise contrary to the requirements of good faith. Again, the plaintiff had a legitimate interest in encouraging the defendant not to exceed the parking time in order to maximize the use of parking for public use, and that the fee was not considered higher than necessary to achieve this goal. Lord Toulson expressed concern that Lord Neuberger and Lord Sampson, in reviewing the integrity test, did not appear to find a significant difference between the test of honesty under the Rules and the test of whether it violates the doctrine of fairness in common law.[162] That, in his Lordship's opinion, ” waters down the test adopted by the CJEU and at the very least [indicates] that the point is not acte clair. ” Needless to say, the majority a priori did not consider the appeal under TFEU section 267 necessary.

In seeking certainty and clarity, the U.K. Supreme Court in *Makdessi* further limits the ability of the courts of England and Wales to intervene to protect parties, both businesses and consumers, from provisions that, at least in the plaintiff's view, impose a disproportionate penalty for breach of contract. This, especially in the consumer context, could lead to results that could be viewed as harsh. According to the court, the fee of 85 pounds in the Beavis case was considered as a commercially legitimate amount that could encourage motorists to comply with temporary restrictions on free parking and thereby ensure a constant flow of customers to the shopping park, while at the same time making it commercially profitable for the company to regulate parking at a profit. However, from another point of view, a pensioner who is delayed in the shopping queue and returns to his car one minute late is unlikely to consider £85 an adequate payment for delay, especially in circumstances that he does not consider his fault. Lords Neuberger and Sampson state in paragraph 33 that: ” The penalty rule is an interference

[162] Ibid.

with freedom of contract. It undermines the certainty which parties are entitled to expect of the law." This negative view of the penalty rule may be justified in the context of arm's length commercial negotiations, but is more controversial in the consumer context. Nevertheless, the UK Supreme Court's reaction to Mr Beavis's plight is not so sympathetic: "The risk of having to pay was wholly under the motorist's own control. All that he needed was a watch".[163] Intervention by other means is therefore necessary to protect the parties from contractual injustice.

With the landmark decision *Cavendish Square Holding BV v Talal El Makdessi/Parking Eye Ltd v Beavis* of the Supreme Court, English law has undergone a remarkable change in the handling of penalty clauses and liquidated damages. The prohibition of the enforcement of penalty clauses has been maintained, while adhering to the legal tradition, but has been pushed back considerably in favor of private autonomy, especially in the b2b area. The classification of a contractual clause as a penalty clause or liquidated damages now follows a methodology that meets the needs of today's contractual practice. For a century, the distinction between penalty clauses and liquidated damages was shaped by the 1915 decision *Dunlop Pneumatic Tyre Co Ltd v New Garage&Motor Co Ltd*.[164] According to this decision, the function which the parties intended the clause to have was decisive. If the other party was to be urgently deterred from breaking the contract by being threatened with a payment obligation exceeding the expected damage, the clause applied as a penalty clause. On the other hand, liquidated damages were to be assumed if the clause embodied a reasonable estimate of the damage, which was intended to accelerate and facilitate the later settlement of damages. The decisive indicator for the delimitation was the value-based comparison of the agreed payment sum and the expected damage. The suitability of this understanding of penalty clauses and their distinction from liquidated damages, in *Dunlop Pneumatic Tyre Co Ltd v New Garage & Motor Co Ltd*[165], has increasingly declined over the course of time as contracts have become more and more complex. The previous approach of distinguishing, between penalty clauses as a means of deterrence and liquidated damages as a serious instrument for estimating the expected damage is too simple to understand and should allow the parties to act accordingly. The clarity, however, became a pseudo-size, since this dogmatics of delimitation and the modern, complex

[163] Ibid.

[164] See footnote 14.

[165] Ibid.

contractual practice could not be reconciled. Especially the contractual forms in the b2b area are too complex to make a fundamental decision about the effectiveness of a contractual agreement solely on the basis of the classification between the two poles of deterrence and serious estimation. The decision in *Cavendish Square Holding BV v Talal El Makdessi/Parking Eye Ltd v Beavis*[166] took this into account without departing from the prohibition of enforcement of penalty clauses altogether. A penalty clause only exists if the payment obligation is not covered by any legitimate interest of the creditor or is not in any comprehensible relation to the legitimate interest. The focus on the creditor's legitimate interest makes sense because it enables a comprehensive assessment of the individual case and, at the same time, opens up more freedom for the court making the determination.Furthermore, the exertion of pressure on the debtor is no longer harmful per se, as long as the creditor tries to enforce a legitimate interest in the performance of the contract. Furthermore, the parties in the b2b area have a prerogative of assessment with regard to the evaluation of the legitimate interests. Provided that both parties have a comparable negotiating position and sufficient legal advice and no excessively high payment sum has been stipulated, the classification of a clause as a penalty clause in the b2b sector is hardly likely.The existence of an enforcement obstacle with regard to penalty clauses has, moreover, at least been justified in a comprehensible manner. Instead of the penalty clauses, English law thus strengthens the application of liquidated damages. With the finality of the fixed amount, these bring advantages for both parties, especially with regard to planning security and the avoidance of costs for intensive legal disputes.

[166] See footnote 150.

3. HOW TO ENFORCE PENALTIES IN INTERNATIONAL COMMERCIAL CONTRACTS AND PROSPECTS FOR HARMONIZATION

The General Assembly of the United Nations, in recommending that States consider adopting the UNCITRAL Uniform Rules (1983),[167] brilliantly summarized the reasons for harmonizing the conflicting common law and civil law rules governing penalties in international commercial contracts: recognizing that a wide range of international commercial contracts contain provisions obliging a defaulting party to pay the other party a specified sum, noting that the effects and validity of such provisions are often uncertain because of the different interpretations of such provisions in different legal systems, believing that these uncertainties constitute an obstacle to international trade, being convinced that it would be desirable to harmonize the legal rules applicable to such reservations in order to reduce or eliminate the uncertainties surrounding them and to remove these uncertainties as obstacles to international trade.

Apart from the UNCITRAL Uniform Rules,various other serious efforts have been made to increase the enforceability of penalties in international trade, but to date there are no transnational rules enforcing penalties in international commercial contracts. The absence of transnational rules in this area of law is due both to a deep discrepancy between civil and common law traditions and to relevant differences within civil law countries. The Benelux Convention on Penalty Clauses of 1973[168] was the earliest and perhaps the boldest of these efforts, even though it was addressed to only three signatory States, such as Belgium, the Netherlands and Luxembourg, with very similar national legislations, all of them members of the same regional trade organization. Subsequently, this issue was deliberately omitted in the Vienna Convention 1980,[169] the most successful treaty proposing uniform rules of trade law. The CISG is a missed chance to establish a path toward harmonization of contractual sanctions, given that its scope is clearly defined, Article 1, ”contracts of sale of goods between parties whose places are in different States” and that parties to the contract can exclude or modify its application according to article 6.

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[167] ”UNCITRAL Model Law on International Commercial Arbitration”, accessed 20 November 2022, https://uncitral.un.org/sites/uncitral.un.org/files/media-documents/uncitral/en/19-09955_e_ebook.pdf.

[168] ”The Benelux Convention on Penalty Clauses of 1973”, accessed 20 November 2022, https://verdragenbank.overheid.nl/en/Treaty/Details/002406 .

[169] ”United Nations Convention on Contracts for the International Sale of Goods (1980) ”, accessed 20 November 2022, https://uncitral.un.org/sites/uncitral.un.org/files/media-documents/uncitral/en/19-09951_e_ebook.pdf .

Beyond the realm of treaties, a number of documents have addressed the question, but none of them is legally binding on states, although potentially useful because parties can designate one of them as the applicable law. In the international arena, the UNCITRAL Uniform Rules 1983 were optimistically followed by a draft convention reflecting the Vienna Convention, although the UNCITRAL Uniform Rules were never adopted.[170] The UNCITRAL Uniform Rules sought a worldwide standard to balance the possibility of civil law enforcement, unless manifestly excessive, with the common law rule of unenforceability. The UNCITRAL Uniform Rules refer to ”contract clauses on the agreed sum due upon failure of perfomance” and exclude unsophisticated parties from their scope - Article 1,[171] providing that these clauses are presumptively valid, so judicial intervention can only be to reduce the agreed amount if it is ”substantially disproportionate” to the actual harm according to article 8. [172] Nevertheless, the civilian approach prevailed,[173] as evidenced by the non-trivial reduction in ”genuine pre-estimate” between the revised draft article G and the final version article 8.[174] For common law countries, public policy concerns against unfair transactions, and the courts' application of two standards of justice, one for domestic and one for international transactions, or simply lack of interest may explain the failure of the UNCITRAL Uniform Rules.[175] In the international arena, the UNIDROIT Principles Article 7.4.13,[176] the main soft law instrument in the field of international commercial contracts, have also settled the issue by following the civil law principle of penalties to be reduced:[177] after giving a broad definition intended to include both liquidated damages and penalties,[178] ”agreed payment for non-performance”, the general rule is to recover specified damages regardless of actual harm article 7. 4.13(1), but the court may reduce these ”grossly excessive amounts” article 7.4.13(2). In the European context, the ”soft law” rules developed by scholars in both the Principles of European Contract Law Article 9:509[179] and the Draft Common Frame of Reference Article III-3:712 [180] follow the pattern

[170] Jonathan S Solórzano, ”An Uncertain Penalty: A Look at the International Community’s Inability to Harmonize the Law of Liquidated Damages and Penalty Clauses,” *Law and Business Review of Americas,*15,4 (2009): 813, https://scholar.smu.edu/cgi/viewcontent.cgi?article=1429&context=lbra .
[171] See footnote 166.
[172] Ibid.
[173] Larry A. DiMatteo, ”Enforcement of Penalty Clauses: A Civil-Common Law Comparison”, *Internationales Handelsrecht* 5 (2010):199.
[174] ”UNCITRAL Model Law on International Commercial Arbitration”, op. cit.
[175] Ibid.
[176] See footnote 147,
[177] DiMatteo, op. cit.
[178] Michael Joachim Bonell, *The UNIDROIT Principles in Practice,* (2nd edition, Transnational Publishers, 2006): 342.
[179] See footnote 146.
[180] See footnote 145.

established by the UNIDROIT Principles: stipulated damages are again referred to as ”agreed payment for non-perfomance” in PECL or ”stipulated payment for non-perfomance” in DCRF, and in both texts the governing rule is that the amount can be recovered regardless of the actual damages, unless the court finds it ”grossly excessive,” in which case the amount will be reduced. The forerunner of these rules was Council of Europe Resolution (78) 3,[181], a set of eight non-binding rules that member states were encouraged to adopt to harmonize civil law regimes. The Council of Europe Resolution (78) 3, considered as a whole, contains much more detailed and elaborate rules than the soft law instruments Unidroit Principles, PECL and DCFR considered so far . This applies not only to the use of a comprehensive definition of punishment, Article 1, and to the appeal to the principle of execution with reduction, Article 7, but also to the prohibition of cumulative punishments (Article 2) and the compatibility of punishment with specific requirements for execution, statutory damage and additional damage, Articles 3, 5 and 6. Impact on the existing civil law codes were minimal, since most of the reforms of national laws in the direction of the above principle had been carried out several years before. Nevertheless, the Council of Europe Resolution (78) 3 can be regarded as a European civil law model of contractual penalties, since it reflects the main characteristics of European civil law: the reasonableness of contractual penalties that may lead to the coercion of a party to fulfill an obligation; judicial review of penalties on the basis of fairness as a discretionary opportunity based on retrospectively, taking into account real losses or on the basis of partial execution; and the right of the recipient of the promise either to a fine or to a specific performance, with the exception of delay.

The lack of transnational rules controlling the enforceability of penalty provisions in international commercial contracts jeopardizes the will of the contracting parties. In addition to the absence of transnational rules, the absence of multi-jurisdictional coordination instruments at the national level means that parties cannot enforce sanctions by resorting to available contractual mechanisms, such as choice of law, choice of court and arbitration clauses. Such contractual mechanisms can be ineffective for a number of reasons, particularly if enforcement is sought by the common law courts hearing the dispute or enforcing a judgment or arbitral award, because mandatory rules of enforcement can never be waived. Clearly, the effectiveness of such contractual agreements is likely to be greater if the parties choose civil law, and the court involved in adjudication or enforcement is also civil law, since common law

[181] See footnote 28.

considerations that might render a penalty invalid would not arise so long as *lex contractus* and *lex fori* belonged to the same legal tradition. For example, if the parties specify Spanish law as the applicable law, and the court of choice is Chile.[182] n the European Union, the effectiveness of such provisions is even higher due to the general rules of private international law concerning contracts, which even allow the parties to deviate from certain mandatory norms. For example, if the parties decide to strictly limit the liability under the contract by using a penalty clause with an unreasonably small agreed amount, the applicable law may be Italian law, appointed to surpass article 1152 of the French Civil Code, when France is the chosen court, so that the judge does not increase the ridiculously low fine on the basis of fairness. The Rome I Regulation Articles 3.3 and 9.1[183] provides such a possibility - only the ”overriding imperative provisions” of the law of the forum will oppose the law chosen by the parties. In this respect, this French rule is binding,[184] but it can hardly be considered an ”overriding mandatory provision” under European Union law. Conversely, the effectiveness of such contractual agreements is questionable if the parties intended to avoid the prohibition of common law on the application of penalties, and the court considering the case or enforcing a foreign judicial or arbitral award is a common law court. The probability of success increases in the following order: only the choice of the law in favor of supporters, the choice of the law in favor of punishment in combination with the choice of the law in a common law court, as well as the choice of the law in favor of punishment and arbitration in a common law country, which is the most reliable way to enforce penalties in international commercial contracts.[185] However, when considering the third option for enforcing penalties in common law countries, it is questionable whether the enforcing court would refuse to recognize and enforce the award, as even the New York Arbitration Convention[186] provides for such refusal if recognition or enforcement is contrary to the public policy of that country (Article V(2)(b)).[187] This ground under the New York Arbitration Convention calls into question the enforcement of an arbitral award in common law countries, particularly in the United States. In the absence of any U.S. court decision, there is no definitive answer to this question yet. Nevertheless, under the case

[182] ”The Chilean Civil Code” , accessed 20 November 2022, https://www.bcn.cl/leychile/navegar?idNorma=1973 .

[183] ”Regulation (EC) No 593/2008 of the European Parliament and of the Council of 17 June 2008 on the law applicable to contractual obligations (Rome I)”, Eur-Lex, accessed 20 November 2022, https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=celex%3A32008R0593 .

[184] See footnote 34.

[185] DiMatteo, op. cit, 200.

[186] ”United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards” ,accessed 20 November 2022, https://www.newyorkconvention.org/english .

[187] Ibid.

law of another common law country, the award will be enforceable.[188] An additional precaution that can be taken, is the advance payment of penalties through an escrow account within the jurisdiction of the chosen civil law forum or in the same civil law country agreed upon for arbitration. Although there may be more than one penalty or penalties of a considerable amount in a contract, none of the potential breaching parties will be inclined to pay the full amount of penalties. Therefore, while payment of potentially due penalty is not fully secured, escrow in an escrow account provides at least partial payment, also acting as a powerful incentive to enforce the obligation.

The harmonization of European and English law with regard to the handling of contractual penalties is necessary in order to take advantage of the many benefits of the legal system in cross-border contractual relationships within the EU.Contractual penalties are of particular importance in the B2B sector. It ensures the provision of services, but also facilitates indemnification, avoids costly and time-consuming legal proceedings and increases legal certainty with regard to the consequences of breaches of contract. The possibility of a free choice of law in the contract in favor of a jurisdiction that does not subject contractual penalties to a prohibition of enforcement is not conducive to achieving the objective. According to the public policy doctrine, the penal doctrine in English law can prevent the enforcement of foreign judgments in Great Britain if they are based on an agreement that qualifies as a penal clause. Furthermore, the harmonization of the law offers the prospect of avoiding problems in the future in inter-European contracts associated with the different approaches to contractual penalties.

The short- and medium-term prospects for a harmonization of the law with regard to the limits of contractual penalties in the EU are low. This negative assessment results from an overall view, although there are clear signs of a convergence for example between German and English law in the handling of contractual penalties. In both legal systems, the courts are increasingly adopting an approach whereby clauses on the legal consequences of breaches of contract are regarded as invalid with greater restraint:for example in Germany apparently by applying §242 BGB to commercial penalty agreements and in English law by repressing the penalty doctrine. The importance of contractual penalties and liquidated damages for B2B business transactions is thus recognized in both jurisdictions and taken into account accordingly. Both legal systems nevertheless provide protection for consumers against

[188] DiMatteo, op. cit, 200.

excessive payment obligations. Moreover, as a result of the *Cavendish Square HoldingBV v Talal El Makdessi/ParkingEye Ltd v Beaviss*[189], both German and now also English law, the creditor's justified interest is the crucial fact to differentiate betweentiate between permissible and unpermissible over payments. A further, gradual convergence between German and English law is conceivable as a result of the networking of the business world that is still to take place, especially if legal practice makes increasing use of the models provided for European contract law in the future. Admittedly, the contrasts between the civill awand common law influenced member states remain, explicitly with regard to the legal consequence system of breaches of contract. The early attempts at harmonization in the mid-seventies failed because of the attempt to impose the continental European ideas on contractual penalties on the common law legal system. The efforts at harmonization by means of the PECL and DCFR seem more promising in comparison. The idea of unifying two conflicting systems by creating a new, single legal institution offered a way out of the seemingly deadlocked situation. However, the model laws cannot be regarded as a breakthrough. The reason for this again lies in the nature of the contractual penalty: the function of securing the fulfillment of the contract, which is linked to the penalty agreement, is very decisively connected with the respective understanding of the law of default. As long as the two legal systems do not converge in dealing with supplementary performance or specific performance, it seems unlikely that the law on contractual penalties will be harmonized, since this is a direct result of the law on supplementary performance. Against this background, it does not seem very practicable if only the legal structure of contractual penalty is changed and then, in contradiction to its legal environment, is transformed into a national law. Also speaks in favor of the efforts for a holistically harmonized European private law. Moreover, it is hardly conceivable that the view of English law will prevail over the view of the law of tort, which is widespread in the majority of the member states. The alternative of a revaluation of specific performance as an equivalent counterpart to damages, in the wake of which the prohibition of the enforcement of penalty clauses may fall, appears to be just as difficult to realize. Nevertheless, the advancing synchronization of the economic world, the convergence of the legal area, and the need for the use of contractual penalty clauses or clauses on the anticipated regulation of the legal consequences of breaches of contract provide sufficient impetus to achieve harmonization in the long term.

[189] See footnote 150.

CONCLUSIONS

With due regard to the topic of the present Master thesis, the indicated aim, and the assigned objectives, the following should be concluded hereupon.

1. The classification of principles of realization of penalty can be carried out according to four criteria:

   1) in relation to the implementation of penalty with the general principles of imposition of responsibility in civil law (principle of inevitability and equality of the parties);
   2) in relation to the object of guaranteeing a penalty, i.e. secured obligation (principle of completeness of guaranteeing an obligation and the real performance of an obligation)
   3) in relation to the subjects of obligatory legal relations: the creditor (the principle of the creditor's interest in the application of a penalty, the debtor - the principle of the offender's guilt in the implementation of a penalty in cases provided by law)
   4) in relation to the penalty itself (the principle of differentiation of the amount of penalty and the grounds for its application), as well as the principle of equivalence of the penalty to the volume of the offense.

2. In the field of penalty clauses, defined as any agreement to pay a fixed sum upon breach of contract, one of the most distinguishing features between the civil and common law systems is the degree of judicial review of the stipulated amount. Whereas common law courts may find such an agreement unenforceable because of the principle of just compensation, civil law courts can only reduce the grossly inflated stipulated amount. Amounts agreed upon in excess of the promisee's actual damages are unlikely to be enforced by Anglo-American judges, and amounts that Continental European judges would find extremely high would also be moderate. At common law the principle of non-performance of contractual penalties applies, and at civil law the principle of performance of contractual penalties subject to reduction.

3. The main difference between the two legal traditions lies in their different conceptions of contractual liability: in common law systems, payment of damages represents the true fulfillment of a contractual promise. Whereas in civil law systems, contractual liability is a consequence arising from a breach or sanction.

4. The purpose and principles of realization of penalty are closely interrelated and interdependent. They derive from the legal nature of the penalty as a form of responsibility, and the functions performed by the penalty, and from the specificity of obligatory legal relations and the subjects of these obligations. Determination of the principles of realization of penalty and their classification on various grounds is of practical importance in terms of establishing the criteria of the amount of penalty, the interest of both parties in the application of penalty and their equality in this case.

5. The analysis clearly shows that civil contract law is more bona fide, or at least closer to the views of mainstream economic science, in its treatment of penalty clauses than is common law. The most rational policy regarding stipulated damages requires a distinction between unconscionable (abusive) and bona fide penalty clauses. Courts should apply penalty clauses generally and overrule only those clauses that are abusive and do not play a special economic role. This ”efficiency test” is possible in any civil contract law, so long as judges consider economic theory when interpreting contracts. This distinction is not unknown to European legal systems, as it is evident in their different treatment of commercial and consumer contracts. The parties can stipulate the damages that best protect their idiosyncratic assessments without fear of being rejected by the courts. The allocation of risk between the parties will be respected in both under- and overcompensation, and the contract can also function as an insurance policy under the blessing of a court that will never upset the balance of the contract established by the parties.

6. Legislation on ”contractual penalties” seems excessively difficult to harmonize, and perhaps not worth the effort. On the one hand, the harmonization of contractual penalties seems irrelevant in B2C contracts, where a clause can be invalidated or unenforceable if it is ”unfair. On the other hand, B2B contracts may use other instruments, such as performance bonds and payment guarantees,94 which may be more effective than indemnification clauses. In many contractual terms, the parties have ”local knowledge” and they can vary the price/performance incentive. Parties can also avoid the costs associated with litigation through a mitigation strategy that they can choose in advance.

RECOMMENDATIONS

1. Enforce penalties in international commercial contracts in common law countries through legislative recognition at the national level. Legislative recognition at the national level should be narrowly focused on penalties expressly agreed upon by the parties in contracts in which at least one of the parties is not a citizen of the country, and the choice of law determines the foreign law under which penalties are allowed. This solution is the most realistic for the enforcement and effectiveness of penalties in international commercial contracts because it would be adopted unilaterally by each individual common law jurisdiction, which implies no cost of coordination and no dependence of success on agreement among a large number of states; and it would be legally binding, which of course means a stronger effect than the optional regime developed in the body of soft law.

2. In order to improve the current legislation and practice of its application, it would be advisable to provide for mandatory pre-trial settlement of disputes on the recovery of liquidated damages or a simplified judicial procedure (in absentia for disputes on undisputed claims).

3. When entering into contracts with commercial partners, great care should always be taken to ensure that the contract, including any penalties for breach of contract, is enforceable. For example, accurately state legitimate interests so that they are protected, and ensure that contractual priorities are expressed as core obligations to circumvent the *Makdessi* test, which could result in the clause being treated as a penalty clause. Also emphasize in the contract that each party received independent advice and was fully aware of the consequences of violating any term of the agreement.

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ABSTRACT

In this article, we will look at one area in which there is a notable difference between civil law and common law - the execution of penalty clauses and, in particular, contractual penalty clauses. This article analyses and compares the rules applying to contractual penalties in Germany, France, Italy and England, as well as in accordance with the UNIDROIT Principles on International Commercial Contracts, PICC and the Principles of European Contract Law, PECL. Also, the different approaches found in these legal systems are scrutinized with regards to their practical implications for contracting parties. This paper demonstrates that there is a need to establish transnational rules for the enforcement of penalty clauses in international commercial contracts because of the lack of contractual instruments that parties can use to address the clash of civil and common law traditions as well as the existing differences between civil law in this area.

Keywords: penalty clauses, contractual penalty, liquidated damages, civil law; common law, freedom of contract, damages, Cavendish Square Holding BV v. Talal El Makdessi, ParkingEye Ltd v. Beavis.

SUMMARY

The article is focused on the study of the features of the legal nature of the penalty as a way to ensure the fulfillment of contractual obligations. The position on the ambiguity of the interpretation of the legal nature of contractual penalty in the legal literature and legislation is substantiated. The differences in the application of penalties in contractual obligations in the law, taking into account the judicial practice on this issue are disclosed.

Attention is paid to the fact that in defining the legal nature of the penalty, most scientists define it as a way to ensure obligations or recognize the dual nature of the penalty. In addition, it is noted that the penalty can be both a way to ensure the performance of contractual obligations and a measure and method of responsibility in the performance of obligations.

This study examines the legal limits of contractual penalties in the form of a comparative analysis of common law and civil law, as well as the laws of different countries. This study examines the constructions of contractual penalties as well as the different ways in which they are applied in order to find out which of the legal systems forms the practice of their application in a more meaningful way to business transactions as a whole or at least part of them. In view of the obvious differences between the legal systems, this paper shows whether there is any prospect of a unified system of contractual penalties in Europe.