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LIQUIDATED DAMAGES AS A LEGAL CONCEPT: A COMPARATIVE ANALYSIS

Master thesis

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INRODUCTION

Actuality of the topic. Famous diplomat, former secretary-general of the United Nations and Nobel Peace prize recipient Kofi Annan once stated that: "It has been said that arguing against globalization is like arguing against the laws of gravity." Countries, businesses and private individuals are becoming increasingly more interconnected to each other. Almost every aspect of life is touched by the globalization processes and contractual relationships do not hold the exception to this rule. Cross-border commercial contracts between parties, on some occasions as legally complicated as made by parties from two separate countries and executable in the third country, are made daily, thus the need of uniformity and harmony regarding it is a constant priority. The need of uniformity caused by rapid expansion of global economy has led to convergence of different legal systems – common and civil law. On one hand, this convergence is stimulated by the lawyers, when drafting contracts they on some occasions stipulate clauses, which are derived from other countries, one the other hand, legal disputes originating from these contracts are judged in the courts and the courts are usually used in interpreting and applying foreign legal concepts according to their national law[1]. The lack of uniformity gives birth to uncertainty. Subjects of economic relationships thus become less eager to enter into contracts, due to the fact that they cannot reasonably foresee their liabilities which may arise and consequently transactional costs become higher. Even though civil law and common law legal systems are gradually assimilating regarding major issues of contract law, there is still no uniformity to the legal concept of liquidated damages.

Liquidated damages clauses serve the function of saving time and resources for the parties to a contract by explicitly stipulating a clause into a contract which establishes the sum of money to be paid as damages following the breach of contract. Nevertheless, regulation of this legal concept is problematic one. In common law countries, mainly England and United States, where it has originated, it is not enforceable if its' purpose is to penalize the other party, rather than compensate the breach for the aggrieved party, in that case it is considered that the clause is actually penal in nature. In civil law legal system penalizing function of agreed damages is permitted, however the court has the right to alter the sum stipulated if it is disproportionate to the actual loss. Furthermore, within this legal system the most popular legal concept of agreed damages being used is penalties while liquidated damages clauses are not that often found in civil codes of continental law countries, only a handful of them, f. e. France and Germany, regulate both legal concepts. Under penalties regime, alteration of this clause is permissible,

[1] E. Meškys. *Liquidated damages instituto esmė, vieta Lietuvos teisės sistemoje ir santykis su bauda ir netesybomis* // Justitia 2012 77, p.52

contrary to liquidated damages clause, where this kind of alteration by the court would contradict the essence of this legal concept. In addition to that, there are some linguistic issues when defining liquidated damages in different legal systems, which add even more confusion to the table. Even from this short overview it becomes clear that the concept of liquidated damages could be full of uncertainty for the parties to a contract and it is in a dire need of regulatory uniformity, which would benefit the efficiency of contractual relations in this rapidly globalizing world of ours.

Novelty of the topic. Although the concept of liquidated damages is not a new one and there has been a lot of attention from legal theorists and researchers as regards to enforceability of penalty clauses and their distinction from liquidated damages, there has been few papers[2] regarding comparative aspects of liquidated damages under common law and under civil law legal systems. Based on linguistic, comparative and other research methods, in order to achieve the aims of the paper, these aspects will be analyzed in this paper. In addition to that, this paper will analyze other, similar to liquidated damages, contractual remedial obligations, their distinction and most importantly, the need of regulatory uniformity of liquidated damages, thus making it original in this regard.

Hypothesis. There is a need of regulatory uniformity regarding legal concept of liquidated damages.

The object of the paper. The concept of liquidated damages in the context of agreed remedial obligations.

The aim of the research. To comparatively analyze the legal concept of liquidated damages, deciding whether there is a need of regulatory uniformity.

The tasks of the thesis:

1. To analyze the legal concept of liquidated damages: definition, purposes and functions.
2. To comparatively analyze regulation of this concept in common and in civil law countries.
3. To distinguish liquidated damages clause from other agreed remedial obligations.

[2] L. Miller. *Penalty clauses in England and France; A comparative study* // ICLQ, Vol. 52, January 2004 // http://discovery.ucl.ac.uk // [Seen on: 2014-02-12]; C. Calleros. *Punitive damages, liquidated damages, an clauses penalés in contract actions: a comparative analysis of the American common law and the French civil code* // 32 Brooklyn J. Int'l L. 67, 2006 // http://www.brooklaw.edu // [Seen on: 2014-02-20]; I. Marín García. *Enforcement of Penalty Clauses in Civil and Common Law: A Puzzle to be Solved by the Contracting Parties* // European Journal of Legal Studies, Volume 5, Issue 1 (Spring/Summer 2012) // http://www.ejls.eu // [Seen on: 2014-02-20]; E.Meškys. *Liquidated damages instituto esmė, vieta Lietuvos teisės sistemoje ir santykis su bauda ir netesybomis* // Justitia 2012 77; D. Bublienė, J. Truskaitė-Paškevičienė. *Iš anksto sutartų nuostolių instituto Jungtinės Karalystės teisėje ir netesybų instituto Lietuvos Respublikos teisėje palyginimas* // Teisė, 2013 Vo. 87; P. Benjamin. *Penalties, liquidated damages and penal clauses in commercial contracts: a comparative study of English and Continental law* // International and Comparative law quarterly, Vol. 9, Oct. 1960.

4. To compare liquidated damages and penalty clauses in common law legal system.
5. To analyze the need of regulatory uniformity regarding this concept.

Methodology. When analyzing and evaluating the relevant literature following research methods are used:

1. *Linguistic* method is being used to analyze various legal acts from different countries, it helps to establish the definition of liquidated damages.
2. *Systemic* method is applied when certain liquidated damages provisions are evaluated in the context of liquidated damages concept as a whole.
3. *Historical* method is used by analyzing the development theory of liquidated damages and different country-by-country approaches towards application of the concept concerning certain periods of time.
4. *Inductive* method is applied by construing conclusions of the thesis and determining the place of liquidated damages provisions in contractual practice.
5. *Document analysis* – used by the examination of periodical articles, codifications and other legal documents in order to ascertain their content and essence.
6. *Comparative* and *logical* methods are used as well to achieve the aims of this paper: to analyze legal regulation of liquidated damages, distinguish it from other legal concepts and evaluate the need of uniformity.

Structure. The thesis contains three sections. The first section reveals the concept of liquidated damages: the origins, purposes, functions, definition and how it is regulated in common law and civil law legal systems. The second section distinguishes liquidated damages from other agreed remedial obligations, and establishes it as a separate legal concept. In addition to that, the second section examines liquidated damages clauses relationship with penalty clauses under common law, which is a crucial aspect to analyze in exploring the validity and enforceability of this concept. The third section is subjected to analyze the current state of regulatory uniformity and the need of further harmonization of liquidated damages. When deciding which questions will be analyzed in the thesis, priority was put on the topics which characterize liquidated damages as a concept the most, as well as the questions which generate the greatest debate amongst legal theorists and practitioners.

1. THE CONCEPT OF LIQUIDATED DAMAGES

1.1 Historical origins

Historically, the law of damages, specifically rudiments of liquidated damages, finds its place in the most ancient codes existing[3]. The Twelve Tables of Rome provide means of reparation for injuries done to a person or a thing. It was the nucleus of the Roman law of damages. The Lex Aquilia had for its purpose the providing of compensation for injuries done to property. It supplemented, but did not repeal the damage provisions of the Twelve Tables, prescribing the measure of damages. These provisions were finally incorporated into the Justinian Digests, where imperial legislator advised his subjects, in making contracts for the doing of anything, to fix the amount of damages by inserting a precise stipulation to that effect. This Roman era provision in its essence is clearly similar as it is used now when defining liquidated damages.

In common law countries the concept of liquidated damages developed from Equity, a set of legal principles that supplement strict rules of law where their application would operate harshly, were it was granted a relief against the harshness of penal bonds. A penal bond was a form of assurance whereby an individual would bind oneself to pay a definite sum of money in the event he failed to perform another primary obligation, the sum was usually twice the amount of their debt. Thus, foundational principle of equity, which provides relief against such bonds, later was adopted by courts of law and until this day remains as the foundation for the rule that penalties are void and unenforceable[4]. However, it is worth mentioning, that later the courts started to realize that, in some situations, where it is not easy to ascertain damages *post factum*, promises to cover a stipulated sum of money in the event of a breach of contract were a valid alternative to the uncertainty of jury's award. Judicial reluctance to embrace liquidated damages is also explainable in part by the fact that public law, as opposed to private law, ordinarily defines the remedies of the parties. Liquidated damages represent a significant departure from courts' traditional responsibility of determining damages, and courts have thus taken it upon themselves to ensure that the private remedy does not stray too far from the legal principle

[3] Lorenzo D. Licup. *A Comparative study of penalty under the civil law and liquidated damages and penalty under the common law* // Phillipine law journal. Volume 5, No. 4, November 1918 // http://plj.upd.edu.ph // [Seen on: 2014-01-27]

[4] William S. Harwood. *Liquidated damages: a comparison of the common law and the uniform commercial code* // Frodham Law Review, Vo. 45, Issue 7 // http://ir.lawnet.fordham.edu // [Seen on: 2014-01-29]

allowing compensatory damages[5]. Former distinction formed the basis for the differentiation between penalties and liquidated damages clauses.

Now, as the circumstances of contractual relations are becoming more and more complicated, participants of various economic activities tend to gradually be extra careful when entering into contract. Thus liquidated damages clause is as relevant as ever before.

Concept of liquidated damages is relatively simple one. At times, when entering into a contract, parties to it *ex ante* reasonably agree on the sum of money to be paid should one of the parties breach the contract. It could be done for various reasons: potential difficulty when having to prove actual losses, existence of this clause makes it easier to compensate the damages, provision acts as some sort of assurance to parties, that their legitimate interests will not be breached. Liquidated damages clauses are especially useful in commercial contracts. Their essential advantage is that the stipulated sum is payable as soon as the breach occurs, there is no need to wait and assess the exact amount of damages suffered. Furthermore, parties to a contract avoid judicial damage recovery proceedings, because compensation is due right after the breach. Advantages and disadvantages of liquidated damages clauses will be examined in a greater detail in following subsections.

Liquidated damages have to be separated from indemnities. In commercial contracts it is customary to agree on compensations, payable by the defaulting party. But in the case of indemnities, exact amount, which is due, is not known until the breach occurs and the scale of damages is clear. In some cases parties agree on incentive payments, f. e., on execution of the contract before its term, but these agreements are performed prior to the breach, as opposed to liquidated damages.

Liquidated damages clauses are most commonly used in construction, information technology development, employment and other contracts. F. e., in construction contracts it is usually indicated, that if construction works will not be completed (product will not be created) in contractors default, latter one will have the obligation of paying agreed upon sum of money for every day or month overdue until the end of the construction to the employer.

In conclusion, the concept of liquidated damages came a long way from its conception to this day, nevertheless not only it is still relevant to commercial relationships, it is becoming even more popular than ever method of ensuring that the legitimate interests of contractual parties will be fulfilled in a way that parties to a contract intended to, thus celebrating the principle of contractual freedom.

[5] Dennis R. L Fiura and David S. Sager. *Liquidated damages provisions and the case for routine enforcement* // Franchise law journal, Spring 2001 // https://www.yumpu.com // [Seen on: 2014-01-29]

1.2 Definition of liquidated damages

Whatever the case may be for putting this clause into a contract, for the purposes of this paper, a definition of liquidated damages should established. Nevertheless it is not an easy task to do, due to the fact that there is a lot of legal systems, which hold diverse point of views defining this clause differently, furthermore, to some of those legal systems this concept does not exist at all. Probably the most universal definition of liquidated damages would be *stipulation in a contract for a fixed sum to be paid as damages for a breach of contract*. Parties to a contract have the right to agree upon the exact amount to be paid or the procedure according to which damages are determined in the event of failure to execute or defective execution of a contract. This agreement has to be put in a contract to be enforceable. Even though this legal concept originated in England, a common law country, and universal definition could be established now, but the differences in development of damages, in a broad sense, in common law and continental law systems determined that there is no uniform regime of liquidated damages between them up until now.

Black's law dictionary defines liquidated damages as a cash compensation, agreed to by signed, written contract for breach of contract, payable to the aggrieved party. The contract succinctly specifies what actions, or omissions, constitute a breach[6]. As it is one of the most commonly used resources in England and United States for legal definitions, it constitutes the approach of common law countries on this legal concept. It is only further evidenced by Lithuanian professor V. Mikelėnas, who when describing definition of penalty in common law countries came to the conclusion that parties, when entering into a contract, can agree on specific sum of money to be paid by the defaulting party to the aggrieved party[7]. According to him, this form of penalty is called liquidated damages. In authors opinion, when making a definition of liquidated damages in common law countries, professor V. Mikelėnas indirectly makes a distinction between penalties, as they are used in Lithuanian and other civil law countries law, and liquidated damages.

In England and United States to be legally enforceable, the nature of a certain contractual clause should determine damages to be circumstantially reasonable and relatively difficult to determine. In other case, a court could rule that the specific clause is a penalty, put in the contract primarily to coerce into performance, and not to compensate the damages. In which case, damages could be considered as unliquidated, to be assigned by the court based on

[6] Black's law dictionary Free Online Legal Dictionary 2nd Ed. // http://thelawdictionary.org/liquidated-damages // [Seen on: 2014-02-05]

[7] V. Mikelėnas. *Civilinės atsakomybės problemos: lyginamieji aspektai.* // Justitia, Vinius, 1995, p. 52

circumstances of the case. In common law countries the term "unliquidated damages" is usually used in tort law[8].

The definition of liquidated damages is rarely used in Lithuanian legal system. Reason for it is that regulation of liquidated damages cannot be found in Lithuanian civil code or other regulatory legal acts. It may be direct causation of the fact that the concept of liquidated damages is absent in UNIDROIT principles and Principles of European contract law, according to which Civil Code of Lithuania was drafted. On the other hand, this legal concept was mentioned in both Supreme Court of Lithuania and Appeal Court of Lithuania case-law. Supreme Court of Lithuania argued[9] that the liquidated damage clause should be distinguished from penalties, thus providing the basis for the argument, that liquidated damages and penalties in Lithuania should be viewed as separate legal concepts[10]. However, in one of its cases[11] the Appeal Court Lithuania, given that fact that liquidated damages are not regulated in Lithuania, came to the conclusion that courts can qualify liquidated damages as penalties, set in Art. 6.71 of Civil Code of Lithuania. In authors' opinion, liquidated damages and penalties are similar yet different legal concepts and one should not be qualified as the other one, because liquidated damages are not prohibited by national laws of Lithuania, this topic will be analyzed in later section of the paper.

Agreement in advance for damages to be compensated for the breach of contract is defined as clause pénale in France. According to the Art. 1226 of the Civil Code of France[12], clause pénale is described as a clause, where on person, the debtor, in order to ensure the fulfillment of the contract commits to the lender in some sort of way. This definition is more extensive than the one which common law countries provide, because it does not limit the debtors commitment to monetary instruments. It entails any agreements designed to ensure the fulfillment of the contract, including stipulating the damages in the event of a breach of contract. In addition to that, some authors claim that the real clause pénale is the one, which prevents the breach of contract, but not the one fixing the agreement between parties for the compensation of damages when the contract is breached[13].

Literal translation of clause pénale may bring some confusion to the table for legal theorists and practitioners. It may be due for several reasons. One of them being, clause pénale is

[8] W. Harpwood. *Modern tort law, Sixth edition*. // West publishing Co. 1990, p.391
[9] 2006 November 6 d. ruling of the Supreme court of Lithuania No. 3K-P-382/2006
[10] D. Bublienė, J. Truskaitė-Paškevičienė. *Iš anksto sutartų nuostolių instituto Jungtinės Karalystės teisėje ir netesybų instituto Lietuvos Respublikos teisėje palyginimas* // Teisė, 2013 Vo. 87 // http://www.vu.lt/leidyba // [Seen on: 2014-02-09]
[11] 2008 April 29 d. ruling of the Appeal Court of Lithuania No. 2A-310/2008
[12] Civil Code of France // http://www.legifrance.gouv.fr // [Seen on: 2014-02-09]
[13] J. Cartwright, S.Vogenauer, S.Whittaker. *Reforming the French law of obligation: Comparative reflections on the Avant-project de réforme du droit des obligations et des la prescription ("the Avant-project Catala")* // Hart publishing, 2009. P.161

a word-to-word translation of penalty clause, which is a legal concept used in common law countries, United States and England most importantly, describing a clause in a contract aimed at stipulating a penalty for a committed breach, but one is legally unenforceable as it is *in terrorem* stipulation, designed not to reasonably compensate the damages, but to force the other party to fulfill the contract or to penalize it for not doing so. In other terms, in its' essence the same definition is used to describe void agreement in common law countries and allowed agreement for the ensuring of obligation fulfillment in France. The other reason, as it was mentioned previously, literal meaning of this definition may cause a presumption that clause pénale in France is intended to punish the defaulting party, but in reality it also compensates the aggrieved party. Art. 1229 part 1 of Civil Code of France clearly states[14] that clause pénale is a compensation for the damages which the creditor suffers from the non-performance of the principal obligation. Regarding all the things previously mentioned conclusion could be made that even though French clause pénale definition consists of penalizing function, deemed void and unenforceable by the courts of England, United States and other common law countries, it also has compensatory function, as in agreements for the compensation to the aggrieved party for the breach of contract, thus it may be considered equivalent to liquidated damages clause.

The terminology problems typically arise when both liquidated damages and penalties are recognized by certain countries or legal systems, whether it is in civil codes, case-law or doctrine, and the terms are used interchangeably[15]. This problem was tried to be solved in the UNICITRAL uniform rules relating to liquidated damages and penalty clauses. There they are collectively defined as contract clauses for an agreed sum due upon failure of performance. UNICITRAL uniform rules stipulate that agreement between parties stipulating the damages *ex ante* is permitted and the form of it, whether it would be a penalty or liquidated damages, is not relevant. Nevertheless, the sum could be reduced by the courts if it is deemed as substantially disproportionate to the actual damages suffered.

In conclusion, even though there are some problematic aspects regarding the definition of liquidated damages, linguistic and perception-based, caused by fundamental differences in legal systems, being the principal ones, they do not conflict with the essence of liquidated damages as a legal tool for the agreeing for the damages *ex ante* for a breach of a contract.

1.3 Liquidated damages: purpose and functions

[14] Civil Code of France, *supra* note 12

[15] J. Frank Mckenna. *Liquidated damages and penalty clauses: a Civil law versus Common law comparison* // ReedSmith, The Critical Path, Spring 2008 // http://m.reedsmith.com // [Seen on: 2014-02-12]

As it was discussed in previous subsection, even though the origins of liquidated damages date back to antiquity, modern concept originated in England. It represents genuine pre-estimate of damages, as opposed to actual damages, which could be more or less than the sum agreed upon in the liquidated damages clause. Contract damages in England are designed to be compensatory, rather than punitive. In the case *Export Credits Guarantee Department v Universal Oil Products* it was stressed[16] that it would be unlawful to permit a provision in a contract which stipulated a sum much higher of the actual loss of the debtor. The court stated: "Perhaps the main purpose of the law relating to penalty clauses is to prevent a plaintiff recovering a sum of money in respect of a breach of contract committed by a defendant which bears little or no relationship to the loss actually suffered by the plaintiff as a result of the breach by the defendant." Thus the distinction between liquidated damages which are permitted and prohibited penalty clauses was established. In respect to this distinction logical conclusion as to what is the main purpose of putting liquidated damages clause into a contract can be made – to genuinely pre-estimate the damages. This conclusion can be supported by a case of *Hadley v Baxendale*, where it was stated[17], that damages for a breach of contract could be awarded if they "may reasonably be supposed to have been in the contemplation of both parties, at the time they made the contract, as probable result of the breach of it."

When a breach of a contract occurs, the courts will aspire to compensate the aggrieved party to whom damages were caused reasoned by a breach of contract, as it is the nature of contract damages. However if damages happened to be too speculative or difficult to determine, the courts may not award them. Liquidated damages clause is a good method to avoid this kind of situation. When analyzing the literature[18], it becomes clear that this is not only advantage of liquidated damages, there are other functions of this clause, which cause it to be stipulated into a contractual agreement by the parties to it:

- Liquidated damages clauses cause some degree of certainty for the parties of a contract concerning the amount of damages for the breach of a contract if it occurs, thus limiting liability;
- These clauses incentivize to fulfill the contract without a delay or other infringements;

[16] The House of Lords in *Export Credits Guarantee Department v Universal Oil Products*. 1983, 2 Lloyd's Rep 152, p. 155.
[17] Exchequer Court in *Hadley v Baxendale*. 1854, 156 Eng. Rep. 145 (ex)
[18] G. Golvan. *Preserving commercial outcomes through binding liquidated damages provisions* // Building dispute practitioners society newsletter 4, 2009; J. Twyford. *Liquidated damages: a comparative study of the law in England, Australia, New Zealand and Singapore* // Journal of professional issues engineering education and practice Vo. 133, No. 3, 2007; B. Eggleston. *Liquidated damages and extensions of time: in construction contracts, Third edition* // A Jogn Willey &Sons, Ltd., 2009

- Aggrieved party has no obligation to mitigate as it would in usual common law claim;
- These clauses make it easier to assess the damages for the delay. It is not necessary to prove circumstances difficult to prove without expenses related to establishing actual losses suffered. This is particularly useful in a contracts, where it is hard to prove the extent of actual loss;
- They provide a possibility to the debtor to undertake cost benefit analysis, which would help him determine if it more commercially beneficial to him to compensate the damages stipulated in the liquidated damages clause or to experience additional costs in trying to uphold the contract;
- The amount of damages, stipulated in the clause, do not have to be proven. Liquidated damages are recoverable as debt thus avoiding the transactional costs in proving the actual loss.

In addition to that, liquidated damages clauses inform in advance all the parties to a contract about the amount of the damages due to be paid in the event of a breach of a contract. This fact is considered to be advantageous to both parties, the one who has the obligation to cover the damages as well as the party who has the right to recover the damages. The damages to be paid become limited, thus the parties have an option to take it into consideration when negotiating the contract. According to some authors[19], liquidated damages clauses promote economic efficiency due to the fact that they cover aggrieved party with a future potential for the breaching party to receive a benefit from a redistribution of resources which weigh down the covering of damages.

Promotion of economic efficiency corresponds to the theory of efficient breach. Generally speaking, this theory states that on some occasions breaching the contract could be so profitable for the party who commits the breach that he would be able to compensate the aggrieved party and economically, both of the parties would be as good as if the breach had never occurred. The theory of efficient breach originated and is accepted in common law countries, to be more specific in the United States, but disregarded in civil law legal system, as it encourages parties to a contract to commit a breach, thus it goes against the basic principles of civil law countries – concept of good faith and Roman era principle *pacta sunt servanda*, which to this date is one of the foundations of contract law.

In general, where there are advantages, disadvantages can be found as well and liquidated damages clauses are not exception from this rule. First of all, estimation of damages in advance is almost always more cost-heavier than estimation after the breach has occurred. All possible

[19] E. Lanyon. *Equity & the doctrine of penalties* // Journal of contract law, Vo. 9, 1996. P.240

consequences of a contract must be taken into account when stipulating damages in advance, as opposed to general compensation of damages, where only information about certain situation has to be assessed and damages resulting from it determined. Moreover, usually there is more information about the situation when the breach has occurred already, thus making it easier to determine the damages. Secondly, when the sum stipulated in liquidated damages clause is a lot lower than the actual losses, party to a contract may be incentivized to breach the contract, thus making the promisee overinsured. Creditor would not breach the contract even if it would be efficient to do so[20].

K. Zweigert and H. Kotz make an argument[21] that "there is a widely accepted principle in comparative law, which states that comparison can only be made between those legal norms that perform the same functions in different legal systems, these are the norms intended to regulate considered the most problematic aspects of life or conflicts of interests." According this argument, after the origins, functions, purposes and definition of liquidated damages are analyzed and established, comparative overview on how this legal concept is regulated in different countries and legal systems should be made.

1.4 Legal regulation of liquidated damages

M. Chen-Wishart argues that the main types of agreed remedial obligations are clauses relating to money payments and distinguishes four types of them[22]:

- An upper limit on the compensation payable on a breach (exemption clauses);
- A particular sum payable on breach (agreed damages/liquidated damages);
- A prepaid sum to be forfeited on breach (deposit);
- Instalments to be forfeited on breach (forfeiture).

Although liquidated damages is a separate category of agreed remedial obligations, some authors believe that on certain occasions other types of agreed remedial obligations can be used as liquidated damages[23], even though they initially do not satisfy the definition of liquidated damages. For instance, liquidated damages are not regulated in China, however Foreign Contract law of the People's Republic of China makes way for the deposits to be used as a means of setting the damages unrelated to actual damages. To be more specific, Art. 14 of the law gives

[20] G. De Geest. *Penalty clauses and liquidated damages* // Encyclopedia of Law and Economics, Volume III. The Regulation of Contracts, Cheltenham, Edward Elgar, 2000, p. 144.
[21] K. Zweigert, H.Kotz. *Lyginamosios teisės įvadas* // Vilnius: Eugrimas, 2001, p. 25
[22] M. Chen-Wishart. *Contract law* // Oxford university press, 2008, p. 586
[23] L. DiMatteo. *A Theory of efficient penalty: eliminating the law of liquidated damages* // American business law journal, Vol. 38, p. 654

permission to the aggrieved party to keep the deposit, if the other party breaches the contract, and if the party, which is in a possession of the deposit, breaches the contract, it has the obligation to cover the amount two times higher than the deposit. It is argued that the concept of deposit forfeiture is more or less the same as *arrhes* doctrine found in Art. 1590 of the Civil Code of France, under which deposit is forfeited when the depositor drops out of the contract, whilst depositor holder has to compensate twice the amount when doing so. *Arrhes* doctrine subsequently can be interpreted as way of using deposits as liquidated damages[24], moreover this doctrine rejects potential penal nature of actions under it. Given the fact that, as previously mentioned, on some occasions other types of agreed remedial obligations could be used and interpreted as liquidated damages, the legal regulation of liquidated damages in their traditional sense, stipulation in a contract, ensuring its fulfillment, for a fixed sum to be paid as damages for a breach of contract, will be analyzed in this subsection.

Under the law of United States, legal concept of liquidated damages is intended to evaluate potential damages caused by failure to fulfill the contract. Liquidated damages clauses are considered to be valid by the court, when it is difficult to determine the actual damages *ex post* the breach of contract and the sum of money due to be paid is reasonable compensation, proportionate to actual or pre-estimate damages. However, if the sum is disproportionate, it may be deemed as a penalty clause, which would mean that the clause would be considered void and damages to be compensated would be limited to the actual damages caused by the breach of contract. Most common law countries, including United Kingdom, Ireland, Australia and Canada have similar rules for liquidated damages and prohibit their usage as penalty clauses. However in India Contract Act makes no distinction between these two concepts and permits to stipulate liquidated damages clauses even if their purpose is to penalize the other party of a contract[25]. The relationship between liquidated damage clauses and penalty clauses in Anglo-American legal system will be discussed in subsequent section of the paper.

United States is a federation, which means that there a federal laws and state laws, this fact explains the lack of uniformity in regulation of liquidated damages on internal basis. In addition to that, it is a common law country, where the main source of law is case-law and statutes only "play second fiddle" in regulating the relationships between individuals. Thus, when evaluating regulation of liquidated damages in United States case-law of federal and state courts along with federal and state statutes have to be taken into account.

Interpretation of liquidated damages clauses differ depending on whether they are interpreted by federal or state courts, but usually courts in United States consider two elements,

[24] Ibid
[25] J. Frank Mckenna, *supra* note 15

when determining enforceability of liquidated damage clause in a particular case[26]. First of all, it has to be decided whether the damage, which is caused by the breach of contract, can be reasonably assessed after it has occurred. Secondly – proportionality, the court will evaluate whether the amount, set in liquidated damage clause, is proportional and reasonable to the damages suffered.

According to the Art. 356 of the Restatement 2nd Contracts[27]: "Damages for breach by either party may be liquidated in the agreement, but only at an amount that is reasonable in the light of the anticipated or actual loss caused by the breach and the difficulties of proof or loss. A term fixing unreasonably large liquidated damages is unenforceable on grounds of public policy as a penalty." Even though non-binding, but it is one of the most cited legal treatise in all United States law areas of law, including contracts and commercial transactions, thus making its provisions relevant on evaluating regulation of liquidated damages in United States. Art. 2-718 of the Uniform Commercial Code[28] has a very similar provision: "Damages for breach by either party may be liquidated in the agreement but only at an amount which is reasonable in the light of the anticipated or actual harm caused by the breach, the difficulties of proof of loss, and the inconvenience or non-feasibility of otherwise obtaining an adequate remedy. A term fixing unreasonably large liquidated damages is void as a penalty." This stipulation sets third element in judging whether certain clause should be considered as a liquidated damages – it should be inconvenient or non-feasible for the party to receive adequate remedy otherwise. It is unclear when this factor has to be weighted. In practice, the courts usually ignore the third element[29]. Uniform Commercial Code is a product of private organizations, therefore to be legally enforceable it has to be enacted by states' legislative body, when enacting specific changes to it can be made, thus only deepening the problem of lack of uniformity in commercial matters in United States. Uniform Commercial Code, or its' various provisions, has been enacted in all 50 states.

The courts of United States examined liquidated damages and other questions, which arise from this clause, a number of times. In the case *Honeywell Int'l Inc. v. Northshore Power Sys., LLC* the court opposed intrusions to the agreements made by individuals and positively assessed liquidated damages as a form of implementation of freedom of contract principle. However, it was acknowledged that it should not deviate from its' compensatory functions. When examining the case *2119 Amsterdam Ave., v Amsterdam 2119, LLC* the court argued that the provision on agreement for stipulated damages would be only valid if stipulated sum would

[26] Ibid
[27] Restatement 2nd Contracts // http://www.lexinter.net // [Seen on: 2014-02-12]
[28] Uniform Commercial Code // http://www.law.cornell.edu // [Seen on: 2014-02-12]
[29] William S. Hardwood, *supra* note 4

be proportionate to actual or expected damages and difficult or impossible to determine after the breach occurs. In this case, 20 percent of the sum of deposit for real estate was considered to be appropriate liquidated damages, given the fact that it would have been difficult for the seller to determine when he could expect to find other buyer and how much he would be willing to pay for said real estate[30].

In England, the concept of liquidated damages is used in the context of payment clauses and compensation of damages. Lucinda Miller points out, that payment clauses are enforceable if they perform the function of liquidated damages, however they are ignored and considered to be void if in reality they are penalty clauses. Determination of the validity of liquidated damages clause means honest and reasonable pre-determination of damages, when deciding whether the amount stipulated is larger or smaller than the one put into the contract[31]. Presented opinion only illustrates apparent legal similarities between United States and England. It can be explained by the fact that the evolution of the American law was highly influenced by English law, therefore legal theory often consolidates these two legal systems under Anglo-American name.

Given the fact that liquidated damages clause is set[32] in Bills of Exchange Act of 1882, Agricultural Holdings (Scotland) Act of 1991, Merchant Shipping (Liner Conferences) Act of 1982, Mineral Workings Act of 1951, Legal Aid, Advice and Assistance (Northern Ireland) Order of 1981 and other various legal acts, in contrary to continental law countries, development of the contents of law, on the most part, in Anglo-American system is designated to the courts, not the legislator.

In the case[33] of *Dunlop Pneumatic Tyre Company Ltd. V New Garage and Motor Company Ltd.* the court looked into relationship between liquidated damages and penalty clauses. It was established that liquidated damages are genuine pre-estimate of damages. The court stressed out that the fact that definition of this clause used in contract should not be ultimate evaluation criterion, whether it is called penalty or liquidated damages. Even though according to definition used, it may be a *prima facie* decided what method is used in ensuring creditors legitimate interests in the contract, however the court has an obligation to evaluate whether it is liquidated damages or penalty clause. It is only supported by preceding case of

[30] G. Bundy Smith, T.J. Hall. *Determining the validity of liquidated damages provisions* // New York Law Journal, Vol. 247, No. 32 // http://www.chadbourne.com // [Seen on: 2014-02-12]
[31] L. Miller. *Penalty clauses in England and France; A comparative study* // ICLQ, Vol. 52, January 2004 // http://discovery.ucl.ac.uk // [Seen on: 2014-02-12]
[32] Bills of Exchange Act 1882: http://www.legislation.gov.uk // Agricultural Holdings (Scotland) Act 1991: http://www.legislation.gov.uk // Merchant Shipping(Liner Conferences) Act 1982: http://www.legislation.gov.uk // Mineral Workings Act 1951: http://www.legislation.gov.uk // Legal Aid, Advice and Assistance (Northern Ireland) Order 1981: http://www.legislation.gov.uk // [Seen on: 2014-02-12]
[33] The House of Lords in *Dunlop Pneumatic Tyre Company Ltd. V New Garage and Motor Company Ltd*, 1914 July 01

Clydebank Engineering and Shipbuilding Co Ltd. v Don Jose Ramos Yzquierdo y Castaneda, where the court decided that a sum *prima facie* would be considered as liquidated damages if it was proportionate to the rate of non-performance and an extravagant or unconscionable or exorbitant provision would not be enforced[34]. One of the reasons why it is so important differentiate liquidated damages from penalty clauses is that if valid they should paid in full, it does not matter whether the actual damages are higher or lower than the one stipulated, or even non-existent. Peter Benjamin argues[35] that this attitude of English law to liquidated damages is very liberal, because the principle of contractual freedom is considered to be one of the most important ones and any intrusion to its fulfillment has to be warranted. In conclusion, if the courts will determine that the contract is valid and circumstances upon which payment is due have arisen, they will not alter agreed upon sum.

B. Eggleston analyzed the concept of liquidated damages in United Kingdom, summarized relevant case-law and came to the conclusion[36] that the courts, when determining the nature of contractual clause, take into account various circumstances, which in some cases are of general nature and some are specific ones, particular to specific cases. For the most part, the courts evaluate the arguments presented by the parties for the purpose of liquidated damages clause, determine provisions' clarity, consider its' ambiguity, reasonableness, grounds of calculating the damages.

Another noteworthy case[37] related to liquidated damages clause is *Temloc Ltd v Errill Properties Ltd*. The rule was established that when parties agree on liquidated damage clause and it is made clear in the contract that if breached contract is to be compensated by liquidated damages clause, the creditor cannot claim for recovery of unliquidated damages. Thus it became clear that the courts in England consider liquidated damages clause to be an exhaustive remedy.

Art. 1152 of Civil Code of France[38] sets a provision that when a contract implicitly specifies an exact sum to be paid by the defaulting party, sum awarded by the court must not be less or exceed that sum. Nevertheless, the judge has a right to *ex officio* alter that amount of money, if it is clearly too small or to large. Provision in a contract, which contradicts this rule is deemed to be invalid.

Civil Code of France in Art. 1226 – 1233 regulates duties emerging from clause pénale. Art. 1226 establishes the definition of penalty, it is a clause in a contract according to which one

[34] Scottish law commission. *Report on Penalty clauses* // Scot Law com No 171, 18 May 1999, p. 6
[35] P. Benjamin. *Penalties, liquidated damages and penal clauses in commercial contracts: a comparative study of English and Continental law* // International and Comparative law quarterly, Vol. 9, Oct. 1960, p. 603
[36] B. Eggleston. *Liquidated damages and extensions of time: in construction contracts, Third edition* // A Jogn Willey &Sons, Ltd., 2009. P 79
[37] The Court of Appeal in *Temloc Ltd v Errill Properties Ltd*, 1988, 39 BLR 30
[38] Civil Code of France, *supra* note 12

party, ensuring the fulfillment of the contract, commits to the other party in some way in the event of default of contract. As it was analyzed in the subsection "Definition of liquidated damages", some of the authors[39] believe that clause pénale found in Civil Code of France is equivalent to liquidated damages, because they serve the same functions and purpose. Art. 1229 states that clause pénale is a compensation for the damages suffered by the creditor for the non-fulfillment of the contract. Creditor does not have the right to demand penalty and compensation herewith, unless it was agreed upon for delay of performance when drafting a contract. According to the Art. 1231 the judge has the right to alter clause pénale if the parties to a contract indicated that this clause is applied in the case of total non-performance, but there was only partial non-performance.

Civil Code of Germany[40], to be more specific Art. 309, lists prohibited contractual clauses, which cannot be evaluated for their validity by the court later on. Lump-sum claims for damages discussed in para 5 of this article in their essence are similar to liquidated damages. Lump-sum agreement for damages or for compensation of a decrease in value is prohibited if:

a) the lump sum, in the cases covered, exceeds the damage expected under normal circumstances or the customarily occurring decrease in value, or
b) the other party to the contract is not expressly permitted to show that damage or decrease in value has either not occurred or is substantially less than the lump sum;

Similarity is apparent due to the fact that these two factors, when deciding whether agreement on lump-sum payments is valid, is basically the same as in two-element test, applied by the courts in Anglo-American system.

Art. 339 – 345 of the Civil Code of Germany regulate penalties solely. Thus the logical conclusion can be made that the Civil Code of Germany makes a distinction[41] between liquidated damages (Ger. *Schadenspauchale*) and penalties (Ger. *Vertragsstrafe*), the difference is that penalties under Art. 343 can be reduced, but liquidated damages cannot, as it is in Anglo-American system. Art. 343 of Civil Code of Germany establishes the right for the court to reduce the sum of penalty stipulated in a contract, given the fact that it is not proportional, setting it to reasonable amount. The court has to take into account all relevant circumstances, like legitimate interests of the creditor and their feasibility, not just his financial interests. Once the penalty is paid, it cannot be reduced.

[39] C. Pejovic. *Civil law and Common law: two different paths leading to the same goal* //VUWLR, (2001) 32 // http://www.upf.pf // [Seen on: 2014-02-12]
[40] Civil Code of Germany // http://www.gesetze-im-internet.de/englisch_bgb // [Seen on: 2014-02-12]
[41] E. Meškys, *supra* note 1, p. 58

Lithuanian laws do not regulate liquidated damages clause, as it is understood in common law countries. Most similar legal concept to liquidated damages in Lithuania, as in other civil law countries, including Germany and France, is a penalty. As opposed to France and Germany, only penalties are provisioned in Civil Code of Lithuania and not both legal concepts. Art. 6.71 of Civil Code of Lithuania defines penalty[42] as a sum of money determined by laws or a contract which the debtor shall be bound to pay to the creditor in the case of failure to perform an obligation, or defective performance thereof. At first glance, it seems that definition of penalty in civil law countries, in this case Lithuania, is the same as liquidated damages under common law, but in fact there is some differences in their functions and purposes, which cause liquidated damage clause to be interpreted as a penalty in civil law countries, if it is not distinguished in relevant laws as separate legal concept, whereas penalty clause would be considered to be void in common law courts, because it is *in terrorem.* Relationship between penalties and liquidated damages will be examined in subsequent section of this paper.

Although liquidated damages clause is not *expressis verbis* regulated in the Civil Code of Lithuania, there are no provisions, which would prohibit the parties to a contract to stipulate the damages in advance by putting this clause into a contract. This position can be grounded by Art. 6.156 para 1, that defines the principle of contractual freedom. Parties are free to enter into contracts and determine their mutual rights and duties at their own discretion. In addition to that, the parties may also conclude other contracts that are not established by this Code if this does not contradict any imperative laws. Art. 6.70 para 1 states that: "Performance of obligations may be secured in accordance with a contract or laws in <…> other forms resulting from the contract." Some authors[43] argue that according to this article of Civil Code of Lithuania liquidated damages clause can be stipulated into a contract, as the Code does not provide exhaustive list of measures for ensuring that contractual obligations would be fulfilled. Provisions of the Civil Code of Lithuania like Art. 6.256 para 1 and para 2 set general rules, according to which every individual has the duty to perform his contractual obligations in a proper way and has a liability to compensate the damages and/or pay the penalty if he breached this duty. Individuals' right to be compensated if he suffers damages along with abovementioned Civil Code provisions create foundation for liquidated damages implementation into Lithuanian legal system. This presumption is confirmed by analyzing the case-law of the Supreme Court of Lithuania. Plenary session of Civil cases division judged[44] on whether a purchase and sales agreement of land should be qualified as a preliminary or principal contract. The court agreed that according to

[42] Civil code of the Republic of Lithuania // http://www3.lrs.lt // [Seen on: 2014-02-13]
[43] E. Meškys, *supra* note 1, p. 70
[44] 2006 November 6 d. ruling of the Supreme court of Lithuania No. 3K-P-382/2006

preliminary contract, monetary payments should not be transferred, however the transfer of money can serve different functions, which would depend on whether preliminary obligations are fulfilled. This case is considered to be benchmark in legalizing liquidated damages in Lithuania as a method of ensuring that contractual obligations are met[45].

[45] E. Meškys, *supra* note 1, p. 60

2. DISTINGUISHING LIQUIDATED DAMAGES FROM OTHER AGREED REMEDIAL OBLIGATIONS

2.1 Comparing liquidated damages and penalties under Civil law legal system

Comparisons between penalties and liquidated damages are caused by the similarity of their essence - both remedies stipulate a sum in a contract to be paid for the breach or non-performance.

The main difference between liquidated damages and penalties under civil law system countries lies in its purpose. The main purpose of liquidated damages, as it was already covered, is to genuinely pre-estimate damages to be paid by the breaching party due to be paid when the breach of a contract occurs. As for penalties, they as well seek to pre-estimate the damages, however they also create some sort of mechanism where a breach will cause such an oppressive burden upon the other party that he will be coerced to complete performance – even if the breach would be more efficient or desirable to him[46]. Albeit there some differences in legal regulation of penalties in certain civil law countries, but the aspect that they all share is that penalties are provisions which seek to deter breach by requiring the payment of extra-compensatory damages[47].

An agreement concerning liquidated damages is meant to eliminate the proof of damages suffered, because the proof of damages is replaced by a lump sum the parties have agreed upon in a contract[48]. The legal determination of the agreement concerning liquidated damages is highly disputed in jurisdiction and among legal authorities. On one hand, liquidated damages clauses are seen as a form of penalty, on the other hand, they are regarded as an agreement *sui generis.* In this respect, opinion is taken that an agreement on a penalty will be in hand if the payment of the agreed sum is primarily meant to ensure the fulfillment of the main contract as well as to coerce the other party into performing it. An agreement on liquidated damages, on the other hand, will be given if the simplified realization of an existing claim of a contract is aimed at. This argument forms second major difference between liquidated damages and penalties, as penalties can be reduced by the court if certain conditions exist and liquidated damages are not reducible.

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[46] J. S. Solorzano. *An uncertain penalty: a look at the international community's inability to harmonize the law of liquidated damages and penal clauses* // Law and Business review of the Americas, Vol. 15, p. 780 // http://studentorgs.law.smu.edu // [Seen on: 2014-02-20]

[47] I. Marín García. *Enforcement of Penalty Clauses in Civil and Common Law: A Puzzle to be Solved by the Contracting Parties* // European Journal of Legal Studies, Volume 5, Issue 1 (Spring/Summer 2012) // http://www.ejls.eu // [Seen on: 2014-02-20]

[48] R. Loeffler. *Penalties and liquidated damages* // Master thesis, Institute of Comparative Law, McGill University, 1981, p. 159.

Countries under civil law legal system do allow the recovery of penalties and it considered a peculiarity[49] that under common law the courts will look at the sum stipulated in the contract, irrespective whether the provision is called liquidated damages or a penalty, and if they determine that the clause is a latter one, they will limit the damages to the amount caused by the breach of contract, in other words to the actual losses. The logic embedded in this kind of treatment of penalties by the courts of Anglo-American courts is a sound one. Considering that the penalties are intended to secure performance of a contract, the debtor is adequately compensated by the covering of his actual loss and he should not be entitled to a sum, although stipulated in a contract, which is not proportional to his actual losses suffered.

On the other hand, contracting parties are not constricted by any rules concerning the sum of money when agreeing for the damages in advance, moreover their intentions, whether they intend to only pre-estimate the damages or to penalize or coerce the other party in performing his obligations, it is completely up to the parties. Moreover, it is supported by the rationality assumption in economics, according to which, individuals are rational, if they make an agreement for a penalty, which is designed to coerce the other party in to performing, they must had a reason for it. Thus the agreement between them is efficient otherwise they would not have made the agreement[50]. This is represents the school of thought of the civil law countries, there penalties are in principle valid. However, as it was previously mentioned and as opposed to common law countries, the courts have the power to alter and reduce the sum stipulated in the penalty clause on some occasions. For example if the sum is excessively larger than the actual damages or if there has been partial performance. In addition to that, if certain conditions exist, the courts may not only reduce the sum stipulated, but to invalidate the penalty clause itself. One of those conditions is contradiction to public policy, like offending good morals, thus acting in a bad faith, or resulting in an unlawful enrichment for one of the parties.

Although it was established that penalties are valid under civil law regime, there are some countries which are exception to this rule. In Belgium, where French civil code is in force, excluding some of its amendments, it is held that only clauses which provide compensation for loss caused by breach constitute penal clauses regulated by the provision of the Civil Code, which *inter alia* provide that the sum specified in the clause can neither be decreased or increased[51].Which means that all coercive penal stipulations are considered to be invalid and contradict the public policy.

[49] B. Eggleston, *supra* note 36
[50] G. De Geest, *supra* note 20, p. 147
[51] Yearbook of the United Nations Commission on International Trade Law, 1979, Volume X, p. 42

The twofold nature of penalties in civil law countries, whereby they are intended to both provide pre-estimate of damages due upon the breach of a contract and in order to guarantee the performance of a contractual obligation, is a consequence by the fact that the purpose of penalties has varied throughout the history. Therefore some historical background has to be provided which has led to existing regulation of penalties under modern civil law regime.

Even though some forms of penalty regulation can be found even in ancient Greece, Roman law gave way for the establishment of penalties as they are known today. Under early Roman law, a single conditional obligation, wholly repressive in nature, was born, were sanction was given to promises that were not legally enforceable . It formed a part of "private" penalties, common to all systems of early law. It followed that the penalty was payable in full even though there had been partial performance, and even where the subject-matter had been destroyed by reason of circumstances beyond the debtor's control. In cases, where penalty was insufficient to cover the damages, the debtor had the right to recover both the penalty and damages. This early form of penalties gave way to the second kind of obligation, which had a dual nature, as it was both repressive and as a mean of determining the damages for non-performing. There the creditor had to choose between covering of the penalty and the covering of the damages, the main obligation was considered fulfilled once the penalty was sought. In later Roman law, couple of the advantages of penalties was stressed, Justinian stressed that the fact that penalties avoid the necessity for a creditor having to prove that the damages are caused by the breach of a contract, in addition to that, the judge do not have not assess the evidence surrounding the damages. At the sunset of Roman era, penalties lost their dual nature and once more became only repressive, meant only for ensuring that contractual obligations are fulfilled, but not pre-estimating damages, which may arise from the breach.

In canon law, which was a link between Roman law and modern civil law, discussion whether penalties could exceed the damages or no was led. There were two schools of thought, on one hand there were *loco interesse*, assessment of damages, which could not exceed the actual damages, on the other hand there were *pro contumacia*, punishment of the debtor, where this stipulation could not be reduced, unless it opposed public order. *Loco interese* can be distinguished from the current position of the common law on agreed damages, where the effect of the clause is to assess damages the amount thus provided for will not be reduced by a court of law, as opposed to a clause *in terrorem* which will be interfered with. However, most importantly this doctrine, where penalties are the means of assessing the damages, which could

be reduced by the court, was later passed on from canon law into civil law. Until the passing of the French civil code, the idea of reduction of penalties was recognized by civil law countries[52].

In the XIXth century Napoleonic code, as enacted in 1804, brought back the principal of literal enforcement that entitled the aggrieved party to recover the agreed sum without any restriction. Napoleonic code is considered as a model for other civil law countries, thus their laws copied this regulation of penalties[53]. Regulation under Napoleonic code did not distinguished penalties from the other clauses in a contract, so if the party to a contract wanted to argue this clause, it had to argue the whole contract.

Nonetheless, Roman era principle of literal enforcement of penalties was progressively abandoned and there has been a widespread trend in European laws towards narrowing the scope of penalty clauses and allowing courts to alter the amount, if the courts deem it to be manifestly excessive[54].

Art. 1152 of Civil Code of France established penalties[55]: "Where an agreement provides that the party who fails to perform it will pay a certain sum as damages, the other party may not be awarded a greater or a lesser sum." In 1975 this article was amended by putting second paragraph to it, which stipulated that the judge may moderate or increase the agreed penalty, where it is obviously excessive or ridiculously low, stipulations which contradicted this paragraph would be considered invalid.

I. Marín García provides some additional peculiarities[56] that distinguish penalties regime in France from other civil law countries. Judicial intervention is exceptional in respect that the disproportion between penalty and actual loss must be an abuse of the coercive function, in order to be altered by the court it has to be obviously excessive, or ridiculously law. It brings us to the second peculiarity of French regulation on penalties, the court has the right to not only diminish the sum stipulated, but it has the right to increase it as well.

What is else noteworthy that under French regime courts are authorized to exercise their judicial discretion when reviewing penalties, once they determine that the stipulated amount of money is too excessive or too low, even in the event of partial performance, thus the court has the right to alter the penalties *ex officio*. Latter mentioned right of the court is statutory granted, thus reinforcing discretionary judicial review.

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[52] P. Benjamin. *Penalties, liquidated damages and penal clauses in commercial contracts: a comparative study of English and Continental law* // International and Comparative law quarterly, Vol. 9, Oct. 1960, p. 610
[53] I. Marín García, *supra* note 47
[54] S. Vitkus. *Penalty clauses within different legal systems* // Social transformations in contemporary society, 2013 (1), p. 157
[55] Civil Code of France, *supra* note 12
[56] I. Marín García, *supra* note 47

As opposed to common law countries, where the reasonability of penalty clauses can be determined both *ex ante*, when the contract is formed, and *ex post*, after the actual damages are clear, the Civil Code of France allows only retrospective test. The courts in France compare the sum stipulated in penalty clause with the actual damages suffered from the breach of contract.

Finally, what is more interesting for the French regulation of penalties, is that cumulative penalties, where creditor is entitled for the payment of penalty as well as the performance of contractual obligation, are not allowed in France, even if this right is clearly granted. Nevertheless, a single exception to this regulation exists. That is for a penalty which is stipulated for a breach caused by a delay, which is not entirely regarded as a cumulative penalty, due to the fact that the performance for this obligation is not possible.

In conclusion, French legal system is peculiar in respect to other civil law countries, because as it was mentioned previously it has specific provisions for both liquidated damages and penalties and due to the fact that the courts have the right to not only reduce penalties, but also to increase them, if it deems the to be ridiculously too low.

Art. 339 – 345 of the Civil Code of Germany[57] regulate penalties. Before examining the legal effect of penalties in Germany, it should be mentioned that they are used often there and for a variety of purposes there, particularly in cases where is hard to prove the actual damages, as in cases on restriction on competition or trade associations. Art. 339 sets a general provision that provided the debtor commits to pay the creditor a fix sum as a penalty for non-performance or partial performance of a contract, it has to be paid. If there is a stipulation for an inaction, penalty has to be paid for the breach, in this case, certain actions of a debtor. Art. 340 and 341 regulate penalties for non-performance and partial performance respectively. According to the Art. 340 para 1, if the debtor pledges to pay the penalty for default of the contract, the creditor has the right to demand to pay the penalty instead of fulfillment of the contract. If the creditor claims the penalty, he forfeits the right to demand to fulfill the contract. Paragraph 2 of this article states that if the creditor has the right to demand to pay the penalty for the failure to execute the contract, he has the full right to require to claim for the penalty as a minimal remuneration for the damages suffered. Assertion of additional damage is not excluded in this case. Thus this provision establishes a minimum rate of damages, allowing the creditor suing on penal clause to recover such damage as he may be able to prove, however the right of claiming both contractual performance and penalty is denied in the Civil Code. Regardless this provision, in practice it is possible to claim for the performance of contractual obligation and for a penalty all together due to the fact that the courts have argued that the provision of Art. 340 can be excluded by the

[57] Civil Code of Germany, *supra* note 40

agreement of contracting parties and the courts have been particularly ready to infer such an agreement where the penalty is designed to coerce the other party into performing agreed contractual obligation as opposed to refraining from doing some act[58]. Similarly to the Art. 340, Art. 341 states that if the debtor commits to pay the penalty for the non-performance, including the delay of performance, creditor gains the right to claim for the penalty or fulfillment of the contract. Creditor has the right to claim the penalty as minimal compensation for the breach of contract and he still retains the right to claim for additional damages. In the event of creditor accepting the performance of the contractual obligations by the debtor, the right to claim penalty only if this right was agreed to be retained at the time of acceptance.

As it was previously mentioned, Art. 343 of Civil Code of Germany establishes the right for the court to reduce the sum of penalty stipulated in a contract, if it is too distant from the actual damages, setting it to reasonable amount. Nevertheless there two more legal possibilities for the debtor to be mitigated from severe effects of contractual penalty clauses by the judicial intervention. First one is the provision found in Art. 138 of Civil Code of Germany, which establishes the principle of good faith, in this regard the court will invalidate the penalty clause that contradicts the principle. Second one is the principle of good faith, found in Art. 157. The courts in Germany frequently use latter provision to reject penal clauses in favor of the debtor. In justifying their intervention on the principle of good faith the courts take into account the purpose of the clause and whether the breach of a contract is such that the enforcement of the penalty clause is justified[59]. In regard of the validity of penalties, the courts tend to examine the fairness of this clause and whether the both parties received adequate benefits in connection to this stipulation. Generally, the courts in Germany consider to be valid large in sum penalty stipulations only if there is wilful misconduct by the other party.

In conclusion, penalty clauses are considered to be extensively popular due to the several factors. First of all, as it is common to regime in other civil law countries and to liquidated damages, the burden of proof is on the debtor rather than the creditor. Secondly, as opposed to wide majority of other European civil laws, creditors are not precluded from pursuing any additional damage to the penalty if they can prove it, in contrary where the creditor is entitled to either a penalty or to specific performance[60].

Under the Art. 6.256 para 2 of Civil Code of Lithuania[61], where a person fails to perform his contractual obligation or performs it defectively, he shall be liable to compensation for damages caused to the other contracting party and/or pay a penalty, thus civil liability in

[58] P. Benjamin, *supra* note 35, p. 618
[59] Ibid
[60] I. Marín García, *supra* note 47
[61] Civil code of the Republic of Lithuania, *supra* note 42

Lithuania has two forms – compensation of damages or paying the penalty[62]. Penalties are established in the Art. 6.71 as a sum of money determined by laws or a contract which the debtor shall be bound to pay to the creditor in the case of failure to perform an obligation, or defective performance thereof. Similarly to regulation in France, the debtor cannot claim for the performance of contractual obligation along with the penalty, unless there was a delay in performance, agreement that stipulated otherwise is invalid. Nevertheless, according to the Art. 6.258 para 2, Lithuania's law permits claiming for the compensation of damages even in the cases where there is agreement on the penalty, however in that case the penalty shall be included in the damages.

D. Bublienė and J. Truskaitė-Paškevičienė have analyzed[63] the main differences between liquidated damages under common law and penalties under Lithuania's law. Even though there are some peculiarities regarding penalty clauses in various civil law countries, the major ones were already mentioned before, and comparison between liquidated damages and penalties only under Lithuanian law is drawn, it could be argued that it compares liquidated damages and penalties in whole civil law regime, due to the fact that regulatory differences are not essential. Differences that were distinguished were the following:

1. Different reference points when evaluating validity of penalty clauses and liquidated damages clauses. When evaluating validity of liquidated damages clauses, the courts will seek to determine whether the clause is a genuine pre-estimate of damages due to be paid when the breach occurs and they would do so considering relevant circumstances when the parties have entered into a contract and their perception by the parties to it. On the other hand, civil law countries focus on circumstances of execution of a contract and the effects of the breach, when evaluating penalties.
2. If common law courts determine that a clause is not liquidated damages, but in fact it is a penal clause, there is a cause to determine this clause to be invalid. Anglo-American courts are not empowered to revise the contents of liquidated damages clause and to alter the sum stipulated by this clause. It is contrary to the position of the courts of civil law countries, where penalty clauses are not invalid *per se*, but the courts have the right to alter the stipulation.
3. Differences in relation with compensation of damages. In most of the civil law countries, with some exceptions already identified, creditor has the right choose either compensation of damages or claiming for the agreed penalty. Under common law regime,

[62] V. Mikelėnas. *Lietuvos Respublikos civilinio kodekso komentaras. Šeštoji knyga. Prievolių teisė. Pirmas tomas* // Vilnius: Justitia, 2003, p.357
[63] D. Bublienė, J. Truskaitė-Paškevičienė, *supra* note 10

liquidated damages clause is an exclusive remedy, meaning if an agreement for liquidated damages is considered valid, the creditor has no right to claim for compensation of damages.

4. Functions of these two legal concepts differentiate. As it was already mentioned, both liquidated damages and penalties have a compensatory function, however liquidated damages are not intended for coercing the other party into performing, while penalties – limiting the liability and they do not provide complete certainty of legal consequences.

The main differences between liquidated damages clauses and penalty clauses listed above directly correlate with major characteristics that define penalties in most of the civil law countries[64].

In conclusion, even though legal concepts of liquidated damages and penalties are very similar forms of agreed remedial obligations, particularly in their essence, they should not be used as synonymous to each other. This subsection listed some attributes of penalties in civil law countries that distinguish them from liquidated damages concept, as it understood in common law countries, thus rational conclusion could be made that these legal concepts constitute separate legal institutes.

2.2 Liquidated damages and other similar in their purpose legal concepts

After the concept of liquidated damages and the differences between it and penalties as they are understood in civil law legal regime was already analyzed, the relationship between liquidated damages and other contractual clauses, which may be different in their form, but when intended for similar purposes as liquidated damages clauses do, could look quite similar.

Art. 6.26 of Civil Code of Lithuania defines the concept of alternative obligations[65]. It is described as an obligation where the debtor is charged with performance of one of two or more different actions (principal prestations) in his own choice or chosen by the creditor or a third person. The performance of either of the chosen prestations shall fully discharge the debtor. Under certain circumstances alternative obligations can be used and interpreted as a liquidated damages clause, for instance if it would be stipulated in the contract that a price of certain goods would be 100 LTL payable on January 1st, but gives the alternative of paying 200 LTL on

[64] 1. The validity of contract penalties, which may have the effect of coercing a party to perform her obligation; 2. The judicial review of penalties on the grounds of equity as a discretionary faculty, based on a retrospective test considering the actual harm, or on the grounds of partial performance; 3. The promisee's entitlement either to the penalty or to specific performance, with the exception of delay, being deprived of claiming statutory damages.
I. Marín García, *supra* note 47

[65] Civil code of the Republic of Lithuania, *supra* note 42

February 1st, may be deemed as liquidated damages, as it set the sanction for non-performance[66]. Nevertheless alternative obligations and liquidated damages are different legal concepts. The alternative obligation is distinguished by the fact that it has only one main obligation which consists of several main benefits, only one of them has to be executed by the debtor so that the contract would be fulfilled. If there is a liquidated damages clause in the contract, there are two distinct obligations, principal one and the conditional, which expires when the main obligation expires, as for alternative obligation, if one the benefits is failed to execute, the obligation remains and does not expire. In addition to that, under liquidated damage clause debtor has no right to choose the obligation that he has to fulfill, due to the fact liquidated damages are due to be paid only if the main obligation is breached, the contract is not fulfilled or fulfilled only partially. In the case of alternative obligations, the debtor has the right to choose the benefit which he undertakes in order to fulfill contractual obligation. Thus even though on some instances alternative obligations may be applied as liquidated damages, they are separate legal concepts and not to be confused.

The pledge or other forms of forfeiture clauses may serve the same function as liquidated damages – to compensate the non-breaching party in the event of a breach of a contract. The pledge is described as a pledging of a movable thing or real rights securing the discharge of an existing or future debt obligation when the object of the pledge is transferred to the creditor, a third person or remains with the pledgor. The object of a pledge remaining with the pledgor may be locked, sealed or marked by marks indicating that it has been pledged[67]. But there are several differences between these legal concepts. First of all, for the liquidated damages clause, the object on which it was agreed upon to compensate the damages, the sum of money usually, remains under disposal of the debtor, in contrary to the pledge, where the object of the compensation is under the control of the creditor. Second of all, the creditor of the obligation with a liquidated damage clause is an unsecured creditor, which comes in competition with the other creditors of that debtor, due to the fact that creditor is not a holder of a real right over the property, sum of money, subject to liquidated damages clause and not having tracking right and right of preference on the asset, as opposed to the pledge, where pledgee is the holder of a real right over the asset, that is under pledge agreement. Therefore, he has three rights: the right to own an asset, the right to claim the asset pledged to third parties and the right of preference[68]. Despite the differences covered, as it was mentioned before, on some occasions the pledge or other forfeiture clauses, like deposit, may serve the same function as liquidated damages.

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[66] Yearbook of the United Nations Commission on International Trade Law, 1979, Volume X, p. 41

[67] Art. 4.198 of Civil code of the Republic of Lithuania, *supra* note 42

[68] F. Ludusan. *The penalty clause. Conventional way of assesing damages* // Challenges of the knowledge society, Vol. 2, 2012. // http://cks.univnt.ro/uploads/ // [Seen on: 2014-03-02]

Limitation clauses are clauses in a contract that do not fully exempt the certain party to a contract from liability, but limit it to a certain amount of money. Thus in contrary to liquidated damages clauses, limitation clauses sets only maximum sum payable in the event of a breach and with obligation to prove this loss, where liquidated damages clauses stipulates an exact sum or a method of calculating it due to be paid upon the breach without the need of proof. It subsequently forms the major differences between the concepts, liquidated damages regime eliminates the proving of actual losses. On the other hand, if the sum stipulated in the limitation clause is higher than the actual damages, this clause may be comparable to liquidated damages. Thus there is a general rule that a liquidated damages clause which is not a penalty acts a limitation of liability in respect of damages for the breach[69].

Indemnity is a promise by one party, indemnifier, to protect the other party, indemnified party, from any loss caused due to an act of the indemnifier or any third party. An indemnity clause thus provides for protection against all kinds of unforeseen and indirect losses, claims and liabilities, howsoever arising, in relation to a specified transaction. Liquidated damages being genuine pre-estimates of damages caused by possible breach of contract, thus this legal concept constitutes only direct or foreseen losses to be claimed by the aggrieved party. This forms the major difference between liquidated damages clauses and indemnities, latter ones provide protection for the creditor against all kinds on unforeseen and indirect losses claims and liabilities in addition to direct and foreseen damage that liquidated damages clauses provide protection for.

Some other forms of contractual clauses may serve the same functions as liquidated damages. For instance, clauses which provide for the payment of certain sum of money other than on the breach of contract, in illustration, specific contractual provisions may stipulate that payment is due when withdrawing from contract. Although liquidated damages clauses require a breach of contract to be enforceable, but compensational nature remain shared between these clauses.

2.3 The relationship between liquidated damages and penalty clauses under Common law

F. O'Farrell Q.C. analyzed the general grounds on which liquidated damages could be challenged and categorized[70] them as follows:

[69] B. Eggleston, *supra* note 36, p. 118

[70] F. O'Farrell Q.C. *Challenging and defending liquidated damages* // Amicus Curiae, Vol. 56, 2004 // http://sas-space.sas.ac.uk // [Seen on: 2014-03-02]

- On a true construction of the provision, it is not applicable to the event that has occurred (e.g. no breach or different breach);
- There is a condition precedent to the application of the liquidated damages provision (e.g. a certificate of non-completion) that has not been satisfied;
- The liquidated damages clause is invalid or void for uncertainty;
- The material contractual machinery is inoperable or has broken down;
- The liquidated damages clause is a penalty.

It was already established and briefly analyzed that a contractual clause that provides a payment by a defaulting party for a sum which is a genuine pre-estimate of loss is enforceable as liquidated damages while a clause which is intended to deter a party from breaching the contract is considered to be a penalty under Anglo-American law system and thus is unenforceable. In the case[71] of *Dunlop Pneumatic Tyre Company Ltd. V New Garage and Motor Company Ltd.*, Lord Dunedin distinguished the essence of liquidated damages and penalties: "The essence of a penalty is payment of money stipulated as *in terrorem* of the offending party; the essence of liquidated damages is genuine covenanted pre-estimate of damage."

The fact is that around second half of 18th century and the beginning of 19th century common law started to develop in the different way from continental law. According to N. S. Marsh[72] on one hand there was the almost unqualified insistence of in the French Civil Code on sanctity of contract and consequent enforceability of penalties. On the other hand there was well-established juristic doctrine that a penalty should be reduced if it is excessive. English law dislikes excessive penalties but it is, like the French Civil Code, anxious to emphasize the sanctity of a contract. The result is the characteristically English distinction between liquidated damages and a penalty in the strict sense.

Thus there is a clear distinction of how common law countries and how civil law countries deal with liquidated damages clauses and penalty clauses. In civil law countries stipulations in a contract that not only pre-estimate the damages, but coerce the other party into performing a contract, i.e. penalty clauses, are generally permissible, however if the court deems that the sum stipulated is manifestly excessive or, in some countries, ridiculously to low, it has the right of altering that amount of money stipulated. However due to the different development of former mentioned legal systems, common law does do not permit the courts to reduce the sum stipulated, so if the courts determine that the clause is actually penal, not a genuine pre-estimation of the damages likely to be suffered, they will consider it to be strictly invalid. They

[71] The House of Lords in *Dunlop Pneumatic Tyre Company Ltd. V New Garage and Motor Company Ltd*, 1914 July 01

[72] N. S. Marsh. *Penal clauses in contracts: a comparative study* // Journal of Comparative Legislation and International Law, Third Series Vol. 32, 1950 // http://www.jstor.org/stable // [Seen on: 2014-03-02]

have an obligation to determine it on case-to-case basis and in doing so, the courts enjoy a certain degree of discretion. Even though this discretion has to be in accordance with certain presumptions, it would be correct to state that in cases of doubt, English courts have permitted penal clauses to be interpreted as liquidated damages in order to maintain well-established principle of sanctity of a contract[73]. Although the courts of civil law have the right to alter penal provision, it can be argued that civil law countries support this principle as well by not invalidating this clause, thus preserving the agreement of the parties more or less intact.

The prohibition of penal clauses in common law countries directly corresponds with the conception of damages within the countries of this legal system. Given the fact that the purpose of awarding the damages is to compensate the aggrieved party, it is thought that it would be unreasonable to permit a stipulation in a contract that establishes a sum which in excess of the actual loss of the obligee. This statement was supported in the case *Export Credits Guarantee Department v Universal Oil Products* Lord Roskill stated[74] that it would be illegitimate to allow a provision in a contract which stipulated a recoverable sum by the plaintiff that has little or no relationship with the damage actually suffered from the breach. Nevertheless the rule against penalties is considered to be an exception to the general rule of English law that a contract should be enforced in accordance with its terms[75].

Distinction between liquidated damages clauses and penalty clauses is mostly relevant in common law countries, as it was already covered civil law countries tend to not differentiate these two concepts when evaluating their enforceability. It is crucial for a parties to a contract to know how the courts would interpret these clauses, because their validity rests on this determination. Over the years the courts established certain set of rules to for distinguishing the valid liquidated damages clauses and invalid penalty clauses, thus the most important source of law regarding it is the case-law of the courts of common law countries.

In the 1829 case[76] of *Kemble v Farren*, which is one of the earliest relevant cases, it was ruled that a payment of a very large sum in consequence of the non-payment of a very small sum should be considered a penalty, thus unenforceable. In 1886 there was a case[77] of *Lord Elphinstone v Monkland Iron and Coal Co.* where it was concluded that in some circumstances a single sum could be presumed to be a penalty. It was said if it could be seen that the loss on one particular breach could never amount to the stipulated sum, then it may be came to the

[73] Ibid
[74] The House of Lords in *Export Credits Guarantee Department v Universal Oil Products*. 1983, 2 Lloyd's Rep 152
[75] The Court of Appeal in *Euro London Appointments Ltd vs Claessens International Ltd*, EWCA 385, 2006
[76] Court of Common Pleas in *Kemble v Farren*, 1829
[77] Court of Appeal of Scotland in *Lord Elphinstone v Monkland Iron and Coal Co.* 11 App Cas 332, 1886.

conclusion that the sum is a penalty. The judge in the case[78] of *Law v Redditch Local Board* stressed that the most important element of differentiating between liquidated damages and penal clauses is the intention of the parties gathered from the whole of the contract. He stated that if the intention is to secure performance of the contract by the imposition of a fine or penalty, then the sum specified is a penalty, however if the intention is to assess the damages for breach of the contract, it is liquidated damages. This case is significant due to the fact that it was established that true intentions of the parties are highly important when deciding whether a certain clause is penal, moreover the intentions are to be found out not only by looking at the argued clause, but by examining the whole contract. In the case[79] of *Public Works commissioner v Hills* the contract between the parties stipulated that if there was a late completion, the contractor would forfeit the retention money as it was liquidated damages. The court decided that the exact amount of retention money depends on the progress of the construction, which means that it is an indefinite sum, thus it could not be held to be a genuine pre-estimate of damages, to specify, it was not liquidated damages.

These rulings constitute the early case-law of English courts regarding the differentiating liquidated damages and penalties. However it is apparent that they do not hold universal criteria for distinguishing the particular legal concepts, but rather stress certain circumstances where liquidated damages are considered to be penalties and unenforced. Fundamental ruling establishing a test whether liquidated damages clause constitutes a liquidated damages provision or a penalty was set by Lord Dunedin in 1915, in the case[80] of *Dunlop Pneumatic Tyre Co Limited v New Garage & Motor Co Limited*. In this case, the manufacturer sold tires to a dealer on the condition that it would not sell tires for less that the list price. If the dealer happened to breach this condition, it had the obligation to pay 5 GBP per tire in liquidated damages. The breach had occurred and the manufacturer claimed for liquidated damages from the dealer. The House of Lords constituted that the stipulated amount was not in fact a penalty, due to the fact that the damages were impossible to determine *ex ante* and the amount to be paid was a genuine pre-estimate of the likely loss conditioned by the breach of contract. Lord Dunedin set out the following relevant principles when assessing liquidated damages clauses:

1. Though the parties to contract who use the words “penalty” or “liquidated damages” may prima facie be supposed to mean what they say, yet the expression used is not conclusive. The Court must find out whether the payment stipulated is in truth a

[78] Queens Bench in *Law v Redditch Local Board*. 1 Queens Bench 127, 1892.
[79] The House of Lords in *Public Works commissioner v Hills*. A.C. 368, 1906.
[80] The House of Lords in *Dunlop Pneumatic Tyre Company Ltd. V New Garage and Motor Company Ltd*, 1914 July 01

penalty or liquidated damages. In addition to that, when finding it out it has to consider all the circumstances of the case[81].

2. The essence of a penalty is a payment of money stipulated as *in terrorem* of the offending party; the essence of liquidated damages is a genuine pre-estimate of damage.
3. The question whether a sum stipulated is a penalty or liquidated damages is a question of construction to be decided upon the terms and inherent circumstances of each particular contract, judged as at the time of the making of the contract, not at the time of the breach.
4. To assist this task of construction various tests have been suggested, which if applicable to the case under consideration may prove helpful, or even conclusive. Such are:
    a) It will be held to be a penalty if the sum stipulated for is extravagant and unconscionable in amount in comparison to the greatest loss that could conceivably be proved to have followed from the breach. Some authors[82] argue that the less parties will look to proportion the stipulated damages with the actual damages that may arise, it becomes less likely that the courts would consider this clause liquidated damages.
    b) It will be held to be a penalty if the breach consists only in not paying a sum of money, and the sum stipulated is a sum greater than the sum which ought to have been paid. In reality, the clauses which are scrutinized under this conditions seem to rarely be regarded as penalties, thus the utility of this rule is being questioned, especially considering the fact that the financial losses arising consequently from non-payment can be substantial and often difficult to calculate[83].
    c) There is a presumption (but no more) that it is a penalty when "a single lump sum is made payable by way of compensation, on the occurrence of one or more or all of several events, some of which may occasion serious and others but trifling damage". Nevertheless this presumption can be rebutted by showing that the particular sum is not an unreasonable estimate of the damage likely to ensue from any individual breach[84]. According to this refutation of the presumption Dunlop convinced the court that the clause was

[81] E. Meškys, *supra* note , p.56
[82] L. Miller, *supra* note 31
[83] Ibid
[84] N. S. Marsh, *supra* note 72

actually liquidated damages and was awarded the compensation. More recent approach of the courts suggest that the courts would not be so receptive to this rule in cases where the clause is fair and reasonable one agreed between parties of equal bargaining strength[85].

d) It is no obstacle to the sum stipulated being a genuine pre-estimate of damage, that the consequences of the breach are such as to make precise pre-estimation almost an impossibility. On the contrary, that is just the situation when it is probable that pre-estimated damages was the true bargain between the parties.

Due to the fact that Dunlop case established four-part test when determining whether a certain contractual clause is liquidated damages or indeed a penalty, it is considered to be a benchmark cases, one that remains highly cited and taken into account over the years.

This test remained more or less unquestioned for nearly hundred years, up until the *Phillips Hong Kong Ltd v Attorney General of Hong Kong* case[86]. Amongst other things the court held that purpose of the ability to *ex ante* agree on damages payable upon the breach of contract was advantageous for both parties, due to the fact that they should be allowed to estimate with a reasonable degree of certainty the extent of their liability as well as the risks they assume. In addition to that, the courts should not take positions against certain contractual clauses, like liquidated damages, which are against their purpose. The court held that it is not enough determine that the actual losses are lesser than the sum stipulated to decide that the clause is penal, mainly it should be determined whether a clause is a genuine pre-estimate of the loss likely to occur. The fact that the case should be judged on the time when the contract was made should not make the facts of what actually happened irrelevant, they provide valuable information on whether the clause was a genuine pre-estimate of damages, whether it was liquidated damages clause.

Both *Dunlop Tyre* and *Phillips Hong Kong* cases stressed the principle that when determining whether a contractual clause is liquidated damages or a penalty clause it should be evaluated if this contractual provision is a genuine pre-estimate of damages likely to occur due to the breach of contract and this determination should be based on time when parties entered into a contract. Differently from *Dunlop Tyre* case, in *Phillips Hong Kong* the court argued that in addition to insignificant or hypothetical drafting problems do not render liquidated damages unenforceable, the courts in general should look to avoid adopting the approach to liquidated

[85] L. Miller, *supra* note 31
[86] Judicial Committee of the Privy Council in *Phillips Hong Kong Ltd v Attorney General of Hong*, 1993

damages which would defeat their purpose. Thus the courts after this case tend to move away from *in terrorem* aspect of distinguishing liquidated damages from penalties[87].

In recent case-law of England the courts tend to willingly look to uphold liquidated damages clause in a commercial agreements negotiated by lawyers of equal bargaining power. Moreover, more flexible commercial justification test is used when deciding whether a contractual clause is liquidated damages or a penalty, under which a liquidated damages clause may be upheld, not as a genuine pre-estimate of loss, but on commercial grounds, provided that its' dominant purpose is not to deter a party from a breach[88].

In conclusion, regardless the fact *Phillips Hong Kong* case introduced a shift towards more liberal approach on justifying liquidated damages clauses, but the rules formulated in *Dunlop Tyre* case are still very much relevant and respected by the courts of common law countries when deciding whether a contractual clause represents a genuine pre-estimate of likely loss caused by the breach of contract and whether it is indeed a penalty, thus non-enforceable.

In United States the principle of non-enforceability of penalties is as deeply rooted as in the other common law countries, but it is considered to be an abnormality, due to the fact that contracting parties lack the power to bargain over remedial rights in legal system in which freedom of contract is a deeply embedded principle[89]. In the case[90] of *Banta v Stamford Motor Co* the court established three-part test on distinguishing liquidated damages from penalties:

1. The damages to be anticipated as resulting from the breach must be uncertain in amount or difficult to prove.
2. There must have been an intent on the part of the parties to liquidate them in advance.
3. The amount stipulated must be reasonable one, that is to say, not greatly disproportionate to the presumable loss or injury.

As the time passed American case-law evolved so the second part of the test is not being used as of now. As for the third part, the reasonableness of the sum stipulated might also be ascertained in the light of both the anticipated or actual loss, as opposed to only anticipated loss at the time of the contracting. Thus only the first part of the test, with its' two elements, the proportionality and difficulty to prove actual damages, is mainly being used under United States legal regime[91]. Later on a new rule was introduced by Art. 2-718(1) of Restatement 2nd of

[87] B. Eggleston, *supra* note 36, p. 87
[88] A. Sorohan, N. O'Higgins. *Recent case law on Liquidated damages and Penalties: Further shift towards a "commercial justification" test* // Arthur Cox, March 2011 // http://www.arthurcox.com // [Seen on: 2014-03-07]
[89] I. Marín García, *supra* note 47
[90] Supreme Court of Errors of Connecticut in *Banta v Stamford Motor Co*. 1914
[91] I. Marín García, *supra* note 47

Contracts: "the inconvenience or non-feasibility of otherwise obtaining an adequate remedy". Even though this provision is incorporated in state laws, it is rarely being used by the courts[92].

In summarization, it is a well known fact that both English and American legal systems are considered to be under common law legal system, moreover, American law was highly influenced by English law. Given the fact that there are some similarities between these legal regimes when differentiating liquidated damages from penalties, f. e. both countries acknowledge the fact that liquidated damages clause have to be proportionate to the actual loss, penalties are considered to be invalid, that the purpose of provisioning them into contracts usually is related to the fact that actual damages may be difficult to prove, still it is apparent that between these two legally similar countries there is no uniform liquidated damages regime, even for separating liquidated damages from penalty clause. This situation is partially caused by the fact that, as already established, common law countries rely heavily on case-law by their respected courts and decision of the courts of one nation highly unlikely could be the primary source of law in another country.

It is matter of great importance to ascertain what happens if a liquidated damages clause is determined to be a penalty by the court and with what options does the creditor remain. In general, the creditor may be still able to claim for general damages, however this process is usually more expensive and lengthy. Moreover, there is another disadvantage of claiming for general damages, as opposed to liquidated damages, the creditor has to prove the loss suffered.

In respect for claiming for damages, there are some problematic aspects to what extent it can be done. Some authors[93] argue:

1. If it is ruled that liquidated damages clause is a penalty, the provision remains part of the original contract and the creditor will be entitled to claim general damages subject to a cap at the level of damages stipulated in the contract;
2. If the liquidated damages clause is defeated due to the fact that it is inoperable or is void for uncertainty, it is eliminated from the contract and the creditors' entitlement to general damages will not be subject to a cap.
3. If the liquidated damages clause is defeated as a result of an act of prevention by the creditor, it is likely that the Court would permit recovery of general damages, but subject to the cap of the stipulated damages.

The opinion where liquidated damages clause after being determined a penalty functions as a limitation on recoverable damages is attested in the case[94] *Jobson v Johnson*, it was noted

[92] Ibid
[93] F. O'Farrell Q.C., *supra* note 70
[94] The House of Lords in Jobson v. Johnson [1989] 1 WLR 1026

that the clause is not simply taken out of the contract, but it still remains in the contract and can be sued on, but it will not be enforced by the court beyond the sum which represents the actual loss of the party seeking payment. To rephrase, it will be enforced to the extent that it does not function as a penalty[95].

It is important to mention that there is different opinion on this matter. It is suggested[96] that penalty should be disregarded and the creditor could claim for his actual loss without limitations as set above. This is due to the fact that the purpose of the clause must be assessed at the time of the conclusion of the contract, thus the resulting loss which was suffered should be irrelevant to the classification between liquidated damages clauses and unenforceable penalty clauses.

As it was already mentioned, recent case law also suggests that the courts are taking a more commercial and flexible approach in determining whether a clause is a liquidated damages or a penalty, especially where the genuine pre-estimate of loss is difficult. This relaxed attitude towards enforcing penalty clauses is supported by the majority of legal researchers, especially economists[97]. D. Brizzee distinguished[98] several aspects for enforcing penalty clauses:

1. Enforcement of penalties upholds the principle of contractual freedom. A contractual provision that has been genuinely and honestly bargained between the parties benefits the parties and third person the most. The parties understand what is most beneficial to them, thus when the courts simply disregards their agreement, they undermine their legitimate interests.
2. Non-enforcement of penalties is "paternalistic". In this case the court demonstrates that the parties are incapable of provisioning their contract fairly and that only the court could establish their true intentions.
3. Penalty clauses provide efficiency in contractual relations. They do so by compensating for idiosyncratic harm, a harm that is suffered by only one party and could only be measured by it, by arguing reliability of party's performance, f. e. party undertakes provision that is penal in its essence, but in doing so it reassures the other party about its' attitude towards the contract, and penalties efficiently allocate risk between parties.

[95] L. Miller, *supra* note 31
[96] Ibid
[97] M. Pressman. *The Two-Contract Approach to Liquidated Damages: A New Framework for Exploring the Penalty Clause Debate* // Virginia Law and Business Review, Vo. 7, 2013 // http://papers.ssrn.com // [Seen on: 2014-03-12]
[98] D. Brizzee. *Liquidated damages and the Penalty rule: a Reassessment* // Brigham Young University Law Review, Issue 4, 1991 // http://www.law2.byu.edu // [Seen on: 2014-03-12]

4. In addition to that, allowing the enforcement of penalty clauses promotes litigation economy by eliminating the need for the court to distinguish it from liquidated damages.

In conclusion, common law countries differentiate liquidated damages from penalty clauses. Where liquidated damages clauses are presented as genuine pre-estimates of loss likely to occur due to the breach of contract, penalty clauses are unreasonable and thus unenforceable. Despite the fact that the courts of common law countries relaxed their position towards the enforceability of penalty clauses by allowing them in debatable situations and consequently familiarizing the whole legal system with continental law, where penalty clauses are enforceable, the tests employed in distinguishing them from liquidated damages clauses are inconsistent and in lack of uniform application across the board.

3. UNIFORMING LIQUIDATED DAMAGES REGIME

Enforceability of a contractual clause is the bottom line of all discussions about the differences between liquidated damages and penalties. According to the principle of contractual freedom parties may put all kinds of stipulations in their agreement, but it all comes down to one thing – whether these stipulations will be legally enforced by the courts of the respected country. In order for the contractual provision to be enforced, it has to be in accordance to the law of the country, where the enforcement is sought. This is where the main problem for the enforcement of liquidated damages clauses and penalty clauses lies, even though we live in a global world, where major legal systems, common law and civil law, are assimilating rapidly, there is an apparent gap in transnational legal regulation, applied in both legal systems, for these legal concepts, which put the will of contracting parties in peril.

As it was already analyzed, liquidated damages clauses that represent genuine pre-estimate of damages likely to be caused by the breach of contract are enforceable in both systems of law, however if in addition the clause is designed to coerce the other party into performing in common law countries it is considered to be penal and unenforceable, where in civil law countries, that were heavily influenced by the Napoleonic code, these clause are generally valid and considered to be an effective method for encouraging performance and avoid litigation. Nevertheless, modern civil codes are departing from the general principle of literal enforcement of penalty clauses, allowing the courts to reduce them if they determine that they are excessive or disproportional to the actual loss suffered. Said modern civil codes were drafted according to 1978 "Resolution on Penalty clauses[99]" issued by the Council of Europe, which aimed at recommending a uniform application of penalty clauses for the member states to use. The resolution allowed penalty clauses, however it was said that the sum stipulated in the clause may be reduced by the courts if it is manifestly excessive, or if part of the main contractual obligation of the contract has been performed[100]. The explanatory memorandum to this resolution provides factors that should be taken into account when deciding whether a penalty is in fact excessive: (I) comparing the size of agreed damages and actual loss; (II) legitimate interests of both contractual parties, including non-pecuniary interests; (III) what type of contract is it and what are the circumstances of entering into it, in respect with social and economic position of the parties; (IV) is the contract standard in form; (V) whether a breach was fair or unfair[101]. The Committee of Ministers recommended that the governments of the member states took into consideration the

[99] Resolution 78(3) of the Committee of Ministers of the Council of Europe; Relating to Penal Clauses in Civil Law
[100] J. Frank Mckenna, *supra* note 15
[101] L. DiMatteo, *supra* note 23, p. 653

principles set in the appendix to this Resolution when preparing new legislation on this subject. In countries under common law legal system, the distinction between liquidated damages and penalties can be used, or deliberately blurred, to allow recovery of many sums which the parties have agreed should be payable in the event of non-performance. Thus it can be argued that a certain degree of compromise has been accepted in order to minimize the tension between respected principle of contractual freedom and the injustice of enforcing an excessively penal provision[102].

In a working Paper by the Working Group on International Contract Practices from April 1981, United Nation Commission on International Trade law UNCITRAL determined that it was crucial to treat both penal clauses and liquidated damages similarly. The Commission noted that there instances where pre-arranged sums are used upon a certain triggering event, but these would not fall under the ambit of the model draft because the payment of the agreed sum was not subject to non-performance or delay. Though these terms are similar to liquidated damages and penalties, they do not quite fit under the same rubric as the two clauses that were focus of UNCITRAL`s attention[103]. The author of this paper agrees with this position, the focal point, which prevents unifying liquidated damages regime across the legal systems is the different treatment of liquidated damages clauses if they are deemed to be penal by the courts. Therefore in order to analyze the efforts for unification of this concept and seeking to harmonize it completely, liquidated damages and penalties have to be treated similarly. This section of the paper is designed to serve this purpose.

First of all, the advantages and disadvantages of current law of common law countries towards these legal concepts should be analyzed and evaluated. The existing law holds the advantage of allowing penalty clauses and liquidated damages clauses to be enforced within limits, because there are solid reasons for enforcing most of these clauses. According to general principle, contracts should be respected, thus when parties entered into contract it should be presumed that it was done for their own benefit, therefore the court should not relieve one of the parties from negative consequences if they occurred. Secondly, desirability that a parties to a contract should be encouraged to perform a contract, penalty clauses serve this desire. Thirdly, liquidated damages and penalties reduce the uncertainty of damages by stipulating them in advance, it has the benefit of diminishing litigation costs or avoid it entirely. Regarding judicial control, existing law allows it due to the fact that the absence of it would cause a situation where the law would be forced to tolerate unjust and extortionate results[104].

[102] Scottish law commission, *supra* note 34, p. 3
[103] J. S. Solorzano, *supra* note 46
[104] Scottish law commission, *supra* note 34, p. 7

On the other hand, probably the main criticism of the existing law is that the liquidated damages test is an imperfect one. It can lead to legitimate and reasonable clauses to be held unenforceable. The test is particularly difficult to apply in those cases where it is impossible to estimate damages in advance, yet such cases are frequently those where the these clauses are most necessary and most useful. Moreover, existing law does not allow judicial control over exorbitant clauses which are functional equivalent of penalty clauses, however which are drafted in such way that they come into operation on the occurrence of something other than the breach of contract[105].

Stressing the fact that in order to ensure unified application and enforceability of liquidated damages and penalties, they have to be treated similarly, the author of this paper believes that for the uniform approach can be reached by regulating the acceptance of penalties on the international basis, including common law countries, where they are generally invalid.

A number of attempts have been made to resolve this matter. The Benelux Convention on Penalty Clauses was the earliest and perhaps the most courageous attempt, despite being addressed solely to three signatory states (Belgium, Netherlands and Luxemburg), with very similar national laws, and all members of the same regional trade organization[106].

Both the Benelux Convention of 26 November 1973 relating to penal clauses, which has not been ratified, and the Pavia Project specify that the clause may prescribe a performance other than the payment of sums of money. Benelux Convention clearly puts forward a single expression - the penalty clause. A penalty clause is: „Any clause which provides that the debtor, if he fails to fulfill his obligation, must pay a sum of money or perform some other service by way of penalty or indemnity". This unitary logic calls for a legal regime which is also unified: the penalty clause only applies in the event of a failure to perform attributable to the debtor, excludes the performance of the obligation to which it is attached and may be reduces by the judge „if manifestly required by equity".

Pavia Project provides that damages are recoverable for the loss sustained and the profits lost which the aggrieved party could reasonably have expected. The loss of the chance of a gain will be taken into account if it can be deemed with reasonable certainty that such gain would occur. The Pavia Project provides that the conduct of the creditor will be taken into account and that such creditor in under a duty to mitigate the loss[107].

[105] Ibid
[106] I. Marín García, *supra* note 47
[107] B. Fauvarque-Cosson, D. Mazeaud. *European Contract law: Materials for a common frame of reference: terminology guiding principles, model rules* // Sellier, European law publishers, 2008, p. 283

In his report[108] on liquidated damages and penalty clauses in 1979 yearbook of the United Nations Commission on International Trade Law Secretary-General listed factors which prevent wider use of penalties and liquidated damages:

1. Clauses seeking to coerce performance are in principle valid in most civil law systems, but are invalid under common law;
2. A validly agreed amount can be varied in the civil law systems, but not under the common law;
3. In civil law systems, the grounds of public policy on which liquidated damages and penalty clauses can be invalidated differ;
4. In civil law systems the extent to which recovery of the agreed amount can be supplemented by other remedies differs;
5. In civil law systems the criteria determining the possibility and extent of reduction of an agreed amount differ;
6. Uncertainty as to the definition of liquidated damages and penalty clauses.

Among other things the Secretary-General noted that the civil law position, which allows penalties, is supported by supporting the need to ensure performance due to inadequacy of damages. Given the fact that penalties, which coerce the other party into performing, are created by agreement, effect is subject to the will of the contracting parties. Possible abuses are prevented empowering the courts to reduce the sum stipulated if it excessive.

The main notion this report corresponds with the idea suggested in this paper. In order to reach unification of these legal concepts, the scope of application of certain transnational regulatory instrument would need to be clear and the formulations of penalty clauses and liquidated damages clauses commonly used in international trade law.

In 1983 UNCITRAL adopted Uniform Rules on Liquidated Damages and Penalty Clauses[109], for international contracts and the General Assembly of the United Nations recommended that States should give serious consideration to the rules and, where appropriate, implement them in the form of either a model law or a convention[110]. The UNCITRAL 1983 Uniform Rules were optimistically followed with a draft convention, mirroring the Vienna Convention, however this Convention was never adopted[111]. The reasons for not adopting it remain unclear for there is little or no record of negotiations outside official documents. What is clear, that the Convention represented a clash between two legal ideologies, common law and

[108] Yearbook of the United Nations Commission on International Trade Law, 1979, Volume X, p. 42
[109] Uniform Rules on Contract Clauses for an Agreed Sum Due upon Failure of Performance and Draft United Nations Convention on Contract Clauses for an Agreed Sum Due upon Failure of Performance. Official Records of the General Assembly, Thirty-eighth Session, Supplement No 17 (A/38/17, annexes 1 and 2).
[110] Scottish law commission, *supra* note 34, p. 2
[111] J. S. Solorzano, *supra* note 46

civil law, and their different positions on unification of these two legal concepts. Concerns were stressed on practical problems related to such ambitious project. Some of the countries have not seen the need of addressing this matter however other ones believed that it is so complicated and problematic that addressing it would be futile, thus there were no consensus even on the importance of uniform approach. Nevertheless, the fact that the Convention and Uniform rules were introduced suggests that most of the countries realized their importance and dedicated time and resources so that they would reach "the light of day", even though to this day the Convention has not been adopted. The UNCITRAL Uniform Rules were aimed to devise a worldwide standard to balance the civil law enforceability, unless manifestly excessive, and the common law rule of unenforceability[112]. UNCITRAL rules apply to international contracts where the parties agreed that upon failure of performance by one party, the other party is entitled to an agreed sum by the obligor, whether as a penalty or as compensation. Thus the rules only complete the intention of the parties. Subject, therefore, to any clause which is different or clause to the contrary, the clause can only apply if the debtor is liable for the failure to perform. The UNCITRAL rules distinguish, always in the absence of any provision to the contrary, between a failure to perform in the event of a delay and the other breaches of performing. In the event of failure to perform, the creditor is entitled to performance of the contractual obligation along with the agreed sum, however if breach is other than failure to perform, the payment of the sum in theory excludes the performance of the contractual obligation except the cases where the agreed sum cannot reasonably be held as sufficient compensation for that breach. In the event where loss substantially exceeds the stipulated amount, the creditor may, if not stipulated otherwise, claim for damages to the extent of the loss not covered by the agreed sum. In addition to that, the clause cannot be reduced by a court or an arbitrator unless it is substantially disproportionate in relation to the loss that has been suffered[113].

In conclusion, Convention which was introduced with 1983 UNCITRAL Uniform Rules on Liquidated Damages and Penalty clauses could be presumed as the best chance never-taken by the international community for unifying the law on liquidated damages. As opposed to the uniform rules themselves, which are not legally binding, convention would have been a serious commitment by the ratifying countries to adopt a regime, which would have harmonized this part of contract law.

[112] I. Marín García, *supra* note 47
[113] B. Fauvarque-Cosson, D. Mazeaud, *supra* note 107, p. 286

Besides international legally binding treaties there is a number of soft-law instruments that tackled the problem of unifying liquidated damages regime. UNIDROIT produced[114] The Principles of International Commercial Contracts. UNIDROIT principles united legal concepts of both liquidated damages and penalty clauses by defining it under single definition: "Where the contract provides that a party who does not perform is to pay a specified sum to the aggrieved party for such non-performance, the aggrieved party is entitled to that sum irrespective of its actual harm". Thus the genuine pre-estimate of damages is eliminated from the equation, putting UNIDROIT suggested regime leaning towards attitude of civil law countries. In addition to this statement, agreed damages are subject to reduction to a reasonable amount where they are grossly excessive in relation to the harm resulting from the non-performance and to the other circumstances. Such reduction is not permitted under the common law, so it is evidenced further that UNIDROIT principles unified liquidated damages regime similarly as UNCITRAL Uniform rules and more resembling civil law approach.

Principles of European Contract law PECL produced[115] by the Commission on European Contract Law and Draft Common Frame of Reference prepared[116] by Study group on European Civil Code, followed the same route as the UNIDROIT principles. PECL unified liquidated damages and penalty clauses by establishing them as agreed payment for non-performance and DCFR – stipulated payment for non-performance. Both legal sources state that the sum is recoverable irrespective of the actual harm with the exception to the cases where courts deem them to be grossly excessive, in which case it would be reduced. Nevertheless, none of these legal sources is legally binding for the states, thus they do not serve the purpose on unifying liquidated damages regime on the mandatory basis, even though they are apparently useful because the parties to a contract may choose one of them as applicable law and in that way avoid any conflicts that may arise if national law would be applicable.

Yet another valuable and commonly used instrument that should be analyzed is United Nations Convention on the International Sales of Goods CISG[117]. Commentaries on the CISG have consistently concluded that the validity of penalty clauses must be determined by reference to domestic national law. The CISG Advisory Council provided that all domestic protection mechanisms generally remain applicable to agreed sums, because CISG is not concerned with the questions of validity. To specify, in the event of the breach the validity of penalty clause will

[114] International Institute for the Unification of Private Law UNIDROIT. *Principles of International Commercial Contracts* // http://www.unidroit.org // [Seen on: 2014-03-17]
[115] Commission on European Contract Law. *Principles of European Contract law PECL* // http://www.jus.uio.no // [Seen on: 2014-03-17]
[116] Study Group on European Civil Code. *Draft Common Frame of Reference DCFR* // https://www.law.kuleuven.be // [Seen on: 2013-03-17]
[117] United Nations Convention on International Sales of Goods 2010 // http://www.uncitral.org // [Seen on: 2013-03-17]

depend on the applicable national law, where in some countries the clause would be deemed valid, in other ones – invalid. Nevertheless, the CISG Advisory Council added that both legal systems prohibiting penalty clauses and legal systems employing the reduction mechanism must respectively decide whether a stipulated sum is a genuine pre-estimate of the loss, or whether a penalty amount is excessive by applying an international standard rather than domestic one[118]. It can be argued that CISG has not established unified regime on liquidated damages and penalty clause, however it advocated that distinction between these two concepts has to be made on international level, thus it advocated uniform approach on this matter.

In conclusion, in the present time there are no significant transnational rules that harmonize the legal concept of liquidated damages in international commercial contracts. There some solutions for unification introduced by UNIDROIT Principles of Commercial Contracts, Principles of European Contract Law (PECL) and Draft Common Frame of Reference (DCFR), however being soft-law instruments, they are not legally binding to the countries, thus ineffective in eliminating the problems conditioned by the lack of uniformity of this legal concept. Conclusion could be made that the lack of transnational rules in this area of law results from both the foundational differences between the civil and the common law legal systems, and the relevant differences within the civil law countries themselves.

Continental Europe is not an exception regarding the absence of uniform rules governing contract penalties or liquidated damages, and historically there has not been a real political will of unifying contract law within the European Union, even though some signs of change were seen in 2010. These signs of change have led to a highly mature and innovative proposal of contract law harmonization, the Proposal for a Regulation on a Common European Sales Law, the scope of which are those aspects which pose real problems in cross-border transactions without extending to aspects that are best addressed by national laws. However, European Sales Law proposed by the Commission does not deal with penalties or with liquidated damages[119].

The reasons arguing for unification of liquidated damages regime are self-evident. In a global environment a wide range of international trade contracts contain clauses obligating a party that fails to perform an obligation under contract to pay an agreed sum to the other party. The effect and validity of such clauses are often uncertain causing their different treatment in various legal systems. These uncertainties constitute an obstacle to the flow of international trade and struck down the confidence and legal certainty of parties before entering into international commercial agreement. Considering these facts it would desirable for the legal rules applicable to such clauses to be harmonized so as to reduce or eliminate the uncertainties which constitute a

[118] S. Vitkus, *supra* note 54, p. 160
[119] I. Marín García, *supra* note 47

barrier on international flow of trade. The most feasible way towards reaching that goal would be adoption of draft Convention which was presented with the introduction of UNCITRAL Uniform Rules on Liquidated Damages and Penalty clauses of 1983. Given the fact that this draft Convention is based on civil law approach on liquidated damages and penalties, where latter ones, even designed to coerce the other party of a contract into performing, are generally allowed and the sum stipulated could be reduced if it is considered to be disproportionate in relation to the loss that has been suffered, it would be complicated to conciliate civil and common law legal systems. Nevertheless, the ratification of this draft Convention would mean that liquidated damages and penalty clauses are harmonized under one definition, the abuse of this contractual clause would be prevented by allowing the courts on certain situations to reduce the amount of money stipulated and most importantly it would be a legally binding document, ensuring the complete unification of liquidated damages regime.

CONCLUSIONS

1. The research has revealed that main attribute characterizing liquidated damages is the intention to genuinely pre-estimate the damages and thus avoid costly and time-consuming litigation procedures, which bring a lot of uncertainty as to what would be the outcome. Uncertainty is an obvious concern in contractual relationships, a concern that liquidated damages clauses help to reduce to a minimum. By stipulating in advance the damages to be paid upon the breach of a contract, liquidated damages serve the function of limiting liability as well as incentivizing the fulfillment of contracts without delays or any other infringements, thus promoting honest commercial environment.
2. Liquidated damages and penalties should be considered as two separate legal concepts. Main differences being: (I) where liquidated damages clauses are genuine pre-estimates of loss likely to occur due to the breach of contract, penalty clauses are held *in terrorem* and thus are unenforceable under common law; (II) if deemed manifestly excessive, penalties may be reduced to the proportionate to the actual loss level. Liquidated damages sum, however, can not be altered, only arguing against the whole clause is permitted. Despite the fact that the common law courts gradually relaxed their strict position towards the enforceability of penalties by allowing them in debatable situations and consequently familiarizing the whole legal system with continental law, the tests employed in distinguishing them from liquidated damages clauses are inconsistent and in dire need of uniform application across the board.
3. The research has showed that considering various regulatory peculiarities, countries can be classified into three categories: (I) where only liquidated damages are regulated; (II) legal regimes, where liquidated damages and penalties are both regulated; (III) where only penalties are regulated. The vast majority of civil law countries have no specific provisions regarding liquidated damages clauses, however they are not usually prohibited by their laws, thus conclusion can be drawn, that even if not explicitly regulated, they are still permissible.
4. It was discovered that there are some other similar in their purpose legal instruments (indemnities, forfeiture clauses, limitation clauses and etc.), nevertheless, they only on some occasions possess certain aspects resembling liquidated damages in their nature, thus should be distinguished from one another as completely different legal concepts.
5. Hypothesis raised in this paper is confirmed. As of now there are no substantial transnational rules that harmonize the legal concept of liquidated damages in international commercial contracts. Solutions regarding unification were introduced by

UNIDROIT, PECL and DCFR, although being soft-law instruments, they are not legally binding to the countries, thus ineffective in eliminating the problems conditioned by the lack of uniformity of this legal concept. The lack of transnational rules in this area of law results from both profound differences between the civil and common law legal systems, and the relevant inconsistencies within the civil law system itself. The need for unification is self-evident. Legal consequences and validity of liquidated damages are often uncertain due to their different treatment in various legal systems. These uncertainties constitute a major obstacle to the international commercial relations and thus it is desirable that liquidated damages be harmonized so as to reduce or eliminate the problems which constitute a barrier on international flow of trade. In authors' opinion, the most reasonable method towards reaching that goal would be the adoption of draft Convention which accompanied UNCITRAL Uniform Rules on Liquidated Damages and Penalty clauses of 1983.

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SUMMARY

Liquidated damages clause is a stipulation in a contract for a fixed sum to be paid as damages for a breach of contract. This contractual provision is becoming increasingly popular amongst parties to a contract due to several reasons. First of all, it sets exact sum or a procedure according to which damages are determined for the breach of contract, thus when the breach actually occurs, there is no need to prove actual loss it can be extremely useful in situations, where it is difficult or impossible to determine actual damages. Secondly, liquidated damages help to avoid costly and time-consuming litigation procedures accompanied by the uncertain decision of the court. Nevertheless, the legal concept of liquidated damages is a problematic one. It is governed by national legal regulations of various countries, therefore there are quite a few differences which prevent parties to a contract from using this concept as they are uncertain of legal implications that it might have. What are these problematic aspects and whether international unification of liquidated damages can solve them require detailed analysis.

The first section of the thesis is intended for the concept of liquidated damages as a whole. The origins of liquidated damages are analyzed, the conclusion is made that the differences regarding liquidated damages regime in civil and common law countries stem from different development of the two respected legal systems. In addition to that, this chapter establishes the definition of liquidated damages as a stipulation in a contract for a fixed sum to be paid as damages for a breach of contract, furthermore the analysis of the purpose and functions of this clause is made. The last subsection is intended to comparatively analyze how liquidated damages are regulated in different countries. England and United States were chosen to illustrate the legal regulation of common law countries while Lithuania, France and Germany represent the civil law legal system.

The second section of the thesis analyzes liquidated damages and other agreed remedial obligations. The stress is put on the most problematic aspects of this legal concept: distinguishing from the most popular form of agreed damages in civil law countries – penalties and other similar in purpose legal instruments, and analyzing the relationship of liquidated damages and penalty clauses under common law legal regime. The analysis has shown that liquidated damages and penalties are separate legal concepts, which may be similar in purpose, yet different in functions thus not to be confused by legal practitioners. In addition to that, penalty clauses are unenforceable in common law countries so provided that the court determines that a contractual clause in indeed penal in nature, it would be invalidated. It was revealed that the legal regulation of liquidated damages is inconsistent amongst and within major legal

systems, causing uncertainty for the parties when deciding whether to include liquidated damages provision into a contract.

The third section of the thesis examines the current state of international legal regulation in relation to liquidated damages. It was discovered that even though there were several attempts in unifying liquidated damages regime in international sphere, but none of theme had any significant influence towards resolving the main issues concerning liquidated damages. Although UNIDROIT, PECL and DCFR suggested quite reasonable approach relating these issues, they are soft-law instruments, thus legally non-binding to countries, albeit parties to a contract may choose them to govern their contract.

In conclusion, the hypothesis of the master thesis was confirmed. There is a lack of harmonization of liquidated damages on transnational basis, thus it was concluded that individuals involved in contractual relations would benefit greatly from uniform legal regulation concerning liquidated damages.

SANTRAUKA

Iš anksto sutarti nuostoliai (- liquidated damages) yra sutarties sąlyga numatanti konkrečią sumą pinigų, kuri turi būti mokama kaip nuostoliai už sutarties pažeidimą. Šis institutas laikui bėgant tampa vis populiaresnis dėl keleto priežasčių. Visų pirma, iš anksto sutartų nuostolių pagalba yra nustatoma konkreti suma, arba jos apskaičiavimo tvarka, mokėtina kaip nuostoliai už sutarties neįvykdymą, todėl įvykus pažeidimui nebereikia įrodyti patirtų nuostolių, šis faktas yra ypač naudingas situacijose, kuriose sunku ar neįmanoma nustatyti faktinę žalą. Antra, iš anksto sutarti nuostoliai padeda išvengti brangių ir ilgai trunkančių teisminių procedūrų, lydimų neprognozuojamais teismo sprendimais. Tačiau iš anksto sutartų nuostolių teisinis institutas yra kupinas probleminių klausimų. Šį institutą reglamentuoja įvairių šalių nacionaliniai įstatymai, todėl kyla reglamentavimo skirtumų. Sutarties šalys nėra tikros dėl galimai kilsiančių teisinių pasekmių, todėl tai apriboja naudojimąsi šiuo teisiniu institutu. Konkrečių minėtųjų probleminių klausimų nustatymui bei ar tarptautinio šio instituto reglamentavimo galimybės juos išspręsti reikalauja išsamaus tyrimo.

Pirma darbo dalis yra skirta iš anksto sutartų nuostolių sampratos analizei. Ištyrus iš anksto sutartų nuostolių istorines ištakas daroma išvada, jog skirtumai tarp bendrosios ir civilinės teisės sistemų iš anksto sutartų nuostolių srityje yra sąlygoti skirtingos šių teisės sistemų raidos. Taip pat šiame skyriuje yra apibrėžiama šio instituto sąvoka, nustatant, jog iš anksto sutarti nuostoliai yra sutarties sąlyga numatanti konkrečią sumą pinigų, kuri turi būti mokama kaip nuostoliai už sutarties pažeidimą. Galiausiai yra ištiriami šio teisinio instituto tikslai bei funkcijos. Paskutinis poskyris yra skirtas lyginamajai iš anksto sutartų nuostolių reglamentavimo analizei skirtingose valstybėse. Anglija ir JAV buvo pasirinktos iliustruoti bendrosios teisės tradicijų teisinį reguliavimą, o Lietuva, Prancūzija ir Vokietija – civilinės teisės tradicijų.

Antroje darbo dalyje analizuojamas iš anksto sutartų nuostolių ir kitų sutartų žalos atlyginimo institutų santykis. Koncentruojamasi ties problematiškiausiais šio teisinio instituto aspektais: atskyrimu nuo populiariausios iš anksto sutartų nuostolių formos civilinės teisės šalyse – netesybų ir kitų, panašių savo tikslais teisinių institutų, ir santykio tarp iš anksto sutartų nuostolių ir baudų bendrosios teisės šalyse. Analizė parodė, kad iš anksto sutarti nuostoliai ir netesybos yra du skirtingi teisiniai institutai, kurių nevertėtų painioti praktikoje. Taip pat, jog baudos yra laikomos negaliojančiomis bendrosios teisės šalyse, jei teismas nustato, jog šios sutarties sąlygos tikslas yra nubausti kitą sutarties šalį už sutarties pažeidimą. Tyrimo metu buvo atskleista, kad iš anksto sutartų nuostolių teisinis reglamentavimas yra nenuoseklus ir tarp skirtingų teisės tradicijų, ir tos pačios teisės tradicijos valstybių tarpe. Tokia situacija suteikia

neužtikrintumą sutarties šalims sprendžiant dėl iš anksto sutartų nuostolių sąlygos numatymo sutartyje.

Trečioje darbo dalyje tiriamas dabartinis iš anksto sutartų nuostolių tarptautinis teisinis reglamentavimas bei šio instituto teisinio reguliavimo suvienodinimo reikiamybė tarptautiniu mastu. Darytina išvada, kad nors ir buvo keletas bandymų tarptautiniu lygiu harmonizuoti šį teisinį institutą, tačiau jie neturėjo reikšmingos įtakos išsprendžiant esmines problemas susijusias su iš anksto sutartais nuostoliais. UNIDROIT, PECL ir DCFR pasiūlė priimtinų šių problemų sprendimo variantų, tačiau kadangi jie yra negriežtosios teisės instrumentai, jie teisiškai nėra privalomi valstybėms, nors ir sutarties šalys gali pasirinkti juos kaip taikytiną teisę savo sudarytoms sutartims.

Daroma išvada, kad magistro baigiamojo darbo hipotezė yra patvirtinta. Tarptautiniu lygmeniu trūksta iš anksto sutartų nuostolių harmonizavimo, jo egzistavimas būtų labai reikšmingas asmenims sudarant tarptautinius komercinius sandorius naudojant iš anksto sutartų nuostolių teisinį institutą.

ANNOTATION

Presented master thesis is titled “Liquidated damages as a legal concept: a comparative analysis.” The thesis analyzes the concept of liquidated damages clause, establishing its’ definition, purposes and functions. In addition to that, liquidated damages are comparatively analyzed with other similar in form or purpose contractual clauses, thus distinguishing it as a separate legal concept, not be confused by practitioners with other forms of agreed damages, such as penalties. Finally, evaluating the need of uniform regime of this legal concept, national and international legal regulation of liquidated damages is examined. It was concluded that there is an apparent absence of uniform legally binding transnational legislation, which would benefit market participants operating in global environment by eliminating uncertainty for legal consequences when entering into contracts.

Keywords: liquidated damages, uniformity.

ANOTACIJA

Magistro baigiamojo darbo tema: „Iš anksto sutarti nuostoliai kaip teisinė koncepcija.“ Darbe analizuojama iš anksto sutartų nuostolių samprata, įtvirtinami šio instituto sąvoka, tikslai ir funkcijos. Negana to, iš anksto sutarti nuostoliai yra lyginami su kitomis, panašiomis savo tikslais ir funkcijomis, sutartinėmis sąlygomis, taip iš anksto sutarti nuostoliai yra apibrėžiami kaip atskiras teisinis institutas, kuris teisinėje praktikoje neturėtų būti tapatinamas su kitomis sutartų nuostolių formomis, pavyzdžiui netesybomis. Galiausiai, yra tiriamas nacionalinis ir tarptautinis iš anksto sutartų nuostolių teisinis reglamentavimas bei įvertinamas šio instituto teisinio reguliavimo suvienodinimo reikalingumas. Daroma išvada, kad šiuo metu yra akivaizdus tarptautinių teisiškai įpareigojančių teisės aktų trūkumas, jų buvimas būtų neabejotinai naudingas globalioje rinkoje veikiantiems rinkos dalyviams, kadangi jis sumažintų teisinių pasekmių neapibrėžtumą sudarant sutartis.

Raktiniai žodžiai: iš anksto sutarti nuostoliai, unifikavimas.

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