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## An Uncertain Penalty: A Look at the International Community's Inability to Harmonize the Law of Liquidated Damages and Penalty Clauses

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# AN UNCERTAIN PENALTY: A LOOK AT THE INTERNATIONAL COMMUNITY'S INABILITY TO HARMONIZE THE LAW OF LIQUIDATED DAMAGE AND PENALTY CLAUSES

*Jonathan S. Solórzano*

## I. INTRODUCTION

AS the global economy rapidly expands and cross-border commercial contracts proliferate, the need to establish harmony between legal systems has never been a more pressing issue. It is troublesome when legal systems are so philosophically divided as to actually impede the free flow of goods and services between countries. When nations lack ideological uniformity, the economic actors working within their legal frameworks face uncertainty. This leads to a reduction in their willingness to enter contracts if their potential liabilities are vague or the transaction costs of dealing with these ambiguities are raised. As it currently stands, both civil and common law systems have developed a robust scheme of contract law and have gradually merged to a consensus on many important issues regarding contract. But, to date, there is still a wide gulf between the two systems' approach to the enforceability of liquidated damages and penalty clauses. It is of extreme importance to international commerce to determine the extent to which these clauses should be enforceable<sup>1</sup>

This paper aims to clarify the reasons that the international regime has thus far failed to agree on a consensus approach to liquidated damages and penalty clauses. These provisions make frequent appearances in a wide array of international trade contracts, but, to date, no binding convention or universally accepted standard has emerged to deal with them.

This paper will begin by giving a historical and philosophical analysis of these clauses, it will then give a brief treatment to the pros and cons of their enforceability, and lastly, the focus of the paper will be to give a detailed breakdown of the United Nations Commission on International Trade Law's (UNCITRAL) attempt at international unification through

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1. Unless parties have explicitly provided for a choice of law clause in their contracts and are aware of what the corresponding conflicts of law rules will be, there is great uncertainty as to the legal treatment of a prearranged sum should one of the parties breach.

the adoption of a convention or model law. It is hoped that through a thorough examination of the working group's discussions, concerns and various drafts, the reader can obtain some insight as to why the United Nations Commission on International Trade Law's (UNCITRAL) was unable to create a harmonized standard for the treatment of liquidated damages and penalty clauses.

#### A. BACKGROUND AND HISTORY

It is a well settled point of law that courts and tribunals are to give effect to the freely consented will of contracting parties as evidenced by their intentions in a contract.<sup>2</sup> Courts do not investigate whether a bargain is a good one unless vitiating factors are present, such as duress, fraud, and the like.<sup>3</sup> The issue of penalty clauses and liquidated damages is atypical in that the legality of these bargained for agreements varies widely by jurisdiction, and the rationale for their disparate treatment is based on fundamentally different ideological stances on their utility vis-à-vis social harm.<sup>4</sup>

It is a fairly safe generalization to say that civil law countries will give legal effect to a clause stipulating that a prearranged sum will be paid upon breach even when that sum is used solely as a coercive mechanism.<sup>5</sup> In common law countries it is likewise safe to make the generalization that a court will not enforce an agreement for one party to pay a prearranged sum in the event of breach if that sum was not meant to be a bona fide pre-estimate of the likely amount of damages.<sup>6</sup>

When discussing these clauses, it is important first to understand what they are and what they are not. Often, one hears the terms 'penalty' and 'liquidated damages clauses' used interchangeably, but they do have important differences. Both penalty clauses and liquidated damages clauses initially serve the same function: they are a pre-arrangement between contracting parties stipulating that, in the event of breach, the breaching party (the obligor) will pay an agreed upon sum—or a formula to arrive at a sum—to the non-breaching party (the obligee). Where penalty clauses differ from liquidated damages clauses, however, is that the purpose of a penalty clause is not to attempt to pre-estimate the possible damage that breach might cause the obligee, but rather it is used as a mechanism where a breach will cause such an oppressive burden upon

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2. Larry DiMatteo, *A Theory of Efficient Penalty: Eliminating the Law of Liquidated Damages*, 38 AM. BUS. L.J., 633, 641 (2001) ("The private bargaining paradigm is premised on the belief that a contract represents the mutual assent of the parties.").

3. KEVIN HOY, *STRUCTURING INTERNATIONAL CONTRACTS: PENALTIES AND LIQUIDATED DAMAGES CLAUSES IN ENGLAND AND IRELAND* 232 (Dennis Campbell Ed., 1996).

4. A discussion of penalty clauses' social (dis)utility will be taken up in further detail on page 8.

5. The Secretary-General, *Report of the Secretary-General: liquidated damages and penalty clauses*, [1979] 10 Y.B. Int'l Trade L. Comm'n 42, U.N. Doc. A/CN.9/161.

6. *Id.*

the obligor that he will be coerced to complete performance—even if breach would be more efficient or desirable to him.<sup>7</sup>

Through the common law lens, an unenforceable penalty exists when the amount to be paid is extravagant “in comparison with the greatest loss that could conceivably flow from the breach.”<sup>8</sup> Case law has articulated that if a clause “is intended by the parties to operate in lieu of performance, it will be deemed a liquidated damages clause and may be enforced by the courts . . . [but] if such a clause is intended to operate as a means to compel performance, it will be deemed a penalty and will not be enforced.”<sup>9</sup>

U.S. jurisprudence is influenced greatly by, and mirrors, the UCC and the Restatement.<sup>10</sup> Prearranged sums payable in the event of breach are not *per se* illegal in the United States. But, whether American courts will enforce a predetermined sum is dependent on two prongs: (1) that the stipulated amount was genuinely intended to compensate the non-breaching party; and (2) the loss caused by the breach is impossible or difficult to quantify, making it hard to get an adequate remedy any other way. UCC §2-718 reads in pertinent part: “(1) 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.”<sup>11</sup> The same section then states in no uncertain terms that “[a] term fixing unreasonably large liquidated damages is *void as a penalty*.”<sup>12</sup>

The UCC view on the legality of penalties seems to be a reflection of one of the key doctrines of U.S. contract law that was articulated in 1881 by Oliver Wendell Holmes when he said “[t]he only universal consequence of a legally binding promise is, that the law makes the promisor

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7. For a description of a penalty clause, see HOY, *supra* note 3, at 244-45 (Describing a penalty clause as: “A sum which, by the terms of a contract made between A and B, A agrees to pay B in the event of non performance by A of one or more of A’s obligations under the contract with B, and which is not a genuine pre-estimate of the damage which is likely to be suffered by B in the event of such breach.” (Citing ECGD vs. Universal Oil Products Company [1983] 2 All ER 205)).

8. Dunlop Pneumatic Tyre co Ltd v. New Garage and Motor Co Ltd, [1915] AC 79. An example of when a common law court found there to be extravagance was in the 1850’s British case *Betts v. Burch* where a clause fixing damages at in relation to any breach of a furniture and stock sale agreement was deemed to be an unenforceable penalty because the amount of £50 applied to *any and all* breaches, even miniscule ones that could under no circumstances have amounted to that amount of damage (£50 in the 1850s was apparently a large sum). Part of the ruling seems to be that the clause operated on a multiplicity of breaches, some of which would not possibly rise to the stipulated amount. It seems if the clause were tailored more specifically to the harm that may be experienced from any individual breach, the court may have found it to be an enforceable liquidated damages clause. See *Betts v. Burch*, 4 Hurl. & N. 506 (1859).

9. *Brecher v. Laikin*, 430 F.Supp. 103, 106 (S.D.N.Y. 1977).

10. HOY, *supra* note 3, at 385-86.

11. U.C.C. §2-718 (2003) (emphasis added).

12. *Id.* (emphasis added).

pay damages if the promised event does not come to pass.”<sup>13</sup> Professor Corbin has expounded on this philosophy by saying “justice requires nothing more than compensation measured by the amount of harm suffered.”<sup>14</sup> Pursuant to this theory, a breaching party can choose to not perform and pay only the expectancy damages to the aggrieved party. Penalty clauses are thus abhorrent to common law courts because they force an obligee to compensate more than the harm that was actually experienced.<sup>15</sup>

Excessive compensation contravenes another central precept of contract law, that “an injured party should not be put in a better position than had the contract been performed.”<sup>16</sup> It should be briefly noted, however, that common law courts *occasionally* do allow extra-compensatory damages in contract as a punitive measure. Traditional contract law has historically forbidden punitive awards for breach, but the modern innovation of the tort of bad faith breach has opened up limited instances where punitive damages may be awarded.<sup>17</sup> Such instances, however, do not include mere opportunism, which is not seen as so egregious so as to warrant punitive action against the breaching party. The tortious breach must amount to something more morally outrageous like intentional misrepresentation, conversion, forgery, or tortious interference with business relationships.<sup>18</sup> The instances where tortious conduct merits a punitive award for contract breach are thus narrowly construed. Other than in these limited instances, common law judges almost never permit compensation that exceeds the contractual harm experienced by the obligee and they tend to mistrust any *arrangement* that might lead to his unjust enrichment.

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13. Aristides N. Hatzis, *Having the Cake and Eating It Too: Efficient Penalty Clauses in Common and Civil Contract Law* 22 INT'L REV. L. & ECON. 381, 386 (2002) (quoting Holmes).

14. ARTHUR CORBIN, CONTRACTS § 1057 (1964).

15. See *In re Plywood Co. of Pa.*, 425 F.2d 151, 155 (3rd Cir. 1970) (“The criteria for distinguishing liquidated damage clauses and penalty clauses are quite general. A penalty is said to be fixed not as a ‘pre-estimate of probable actual damages, but as a punishment, the threat of which is designed to prevent the breach’ . . . In addition, the liquidated damages stipulated must not be disproportionate to the probable loss judged as of the time of making the contract.”).

16. *Truck Rent-A-Center v. Puritan Farms 2nd, Inc.*, 41 N.Y.2d 420, 424 (N.Y. 1977) (“A promisor would be compelled, out of fear of economic devastation, to continue performance and his promisee, in the event of default, would reap a windfall well above actual harm sustained.”); Hatzis, *supra* note 13, at 387. It should be noted briefly that the idea of barring compensation above and beyond the harm suffered seems inconsistent with the United States’ willingness to enforce punitive damages awards in tort actions. Many commentators puzzle over this contradiction in American jurisprudence, but it is beyond the scope of this paper to discuss in detail the history and policy motivations that underlie this apparent aberration. For a further discussion of super-compensatory damages in contract, see John A. Seibert, Jr., *Punitive and Nonpecuniary Damages in Actions Based Upon Contract: Toward Achieving the Objective of Full Compensation*, 33 UCLA L. REV. 1565 (1986); Dorsey D. Ellis, Jr., *Fairness and Efficiency in the Law of Punitive Damages*, 56 S. CAL. L. REV. 1 (1982).

17. DiMatteo, *supra* note 2, at 650.

18. *Id.* at 650 n.53.

Besides the judicial apprehension towards unjust enrichment, common law also finds it inappropriate for private litigants to punish each other—retribution should be left exclusively to criminal tribunals.<sup>19</sup> Countries with legal systems modeled after the Napoleonic Code, conversely, tend to give full credence to the will of parties, even if the agreement has the effect of punishment. Civilians see contract as a right that the court has an obligation to enforce. These civil systems view penalty clauses as an efficient way to encourage performance, which leads to more commercial certainty and reduces the costliness of litigation to determine damages after the fact.<sup>20</sup> Furthermore, just as common law contract jurisprudence demands that judges not evaluate the adequacy of consideration of the parties, civilians generally do not see it as the judge's role to assess the adequacy or fairness of the *remedy* prescribed by the agreement.<sup>21</sup>

The common law's judicial loathe for penalty clauses has a long history in common law countries, but it has not always been the case that these courts have shunned penalties. Up until at least the Seventeenth Century, English courts enforced penal bonds, which were sealed instruments that aimed to ensure performance by stipulating the payment of a sum of money well in excess of the value of the contract itself (usually two times the amount of the contract).<sup>22</sup> As the jurisprudence developed over the following centuries, English courts—and consequently all common law

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19. *Rattigan v. Commodore Intern. Ltd.*, 739 F.Supp. 167, 169 (S.D.N.Y. 1990) ("Although freedom of contract is at the core of contract law, the 'freedom to contract does not embrace the freedom to punish, even by contract.'"); see also *Discussion Paper on Penalty Clauses* 4 (Scottish L. Comm'n, Discussion Paper No. 103, 1997); Note that common law tribunals do, however, often award punitive damages in actions of *tort*. Discussion of this aberration is beyond the scope of this paper, but it is fair to assert that common law countries—except in very limited circumstances such as tortious breach—will not allow private litigants to enforce contractual provisions that have the effect of punishing the obligor.

20. Report of the Secretary-General, *supra* note 5.

21. DiMatteo, *supra* note 2, at 643. Note, however, that judges are free to adjust penalty causes downward if they are so excessive or if there are other extenuating circumstances that would warrant a reduction. See C. Civ. art. 1152 (as amended in 1975 and further amended in 1985) (Fr.) ("Nevertheless, the Judge may, even of his own accord, reduce or increase the agreed-upon penalty if it is manifestly excessive or ridiculously small. Any contrary stipulations will be considered not written."); Schweizerisches Obligationenrecht [OR], [Code of Obligations] art. 163 (Switz.) ("An excessively high penalty has to be reduced by the court, according to its discretion") Bürgerliches Gesetzbuch [BGB] [Civil Code] § 343 (F.R.G.) ("If a forfeited penalty is disproportionally high, the court may upon the obligor's request reduce it to an appropriate amount. In determining the question of what is appropriate, every rightful interest of the obligee, not only his monetary interest, has to be considered") (Note that under German law, judicial modification is not permitted in contracts where the obligor is a merchant, presumably these parties should be sophisticated enough to caution against oppressive clauses—§ 348 of the German Commercial Code says a "contractual penalty promised by a merchant in the course of his business cannot be reduced"); See also Report of the Secretary-General, *supra* note 5 (that judicial neutrality is limited in the event that the penalty clause has a gross or excessive disparity from harm. Only then is some judicial adjustment is allowed. Judges are also given leeway to adjust a penalty down if there has been partial performance, it offends good morals, it is contrary to good faith or unjustly enriches the other party).

22. Hatzis, *supra* note 13, at 384.

courts—gradually began striking these types of onerous provisions on public policy grounds, positing that their enforcement was unreasonable because weak parties must have lacked sufficient bargaining power.<sup>23</sup> To this day, U.S. courts retain this vestige of common law paternalism towards the perceived inequitable bargaining power that *must have* occurred for parties to have entered into these types of arrangements.<sup>24</sup> The United States has held fast to this view in spite of the criticism of many commentators, and despite the apparent success of civil law courts treating penalties liberally. Civilians believe that unless the sum is seriously inequitable, it should not be inquired into for legitimacy.<sup>25</sup>

#### B. EFFICIENT BREACH OR INCREASED RELIANCE?

Though protection of weak parties was the initial motivation to strike down penalty clauses, as case law matured in common law countries, a less paternalistic rationale was invoked as a reason for the non-enforcement of these clauses. Economists lauded the principal of “efficient breach,” where, as the theory goes, if parties are free to break their bargains should a better deal come along, rational actors will breach their first contract, pay the expectancy damages to the obligee, and pursue the more lucrative alternative. Presumably, this will have a net benefit to society because resources are being channeled to the user who values them most.

For instance, assume the following scenario: Acme Contractors agrees to build an office building for Fred Firstbuyer for an agreed price of \$100,000 to be completed by August 31st. Acme Contractors is about to begin work on the office building but is subsequently approached by Ivan Interloper who offers to pay Acme \$200,000 if they will build him a home by August 31st. Since Acme is a small company—it lacks the personnel

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23. DiMatteo, *supra* note 2, at 643-44 (These clauses were not stricken because of the traditional notion of unconscionability—the unconscionability doctrine requires both substantive and procedural unconscionability—whereas “the law of liquidated damages allows a court to void an express term [solely] upon [a] finding of unreasonableness. No procedural shortcomings need be shown to invalidate a liquidated damages clause”).

24. DiMatteo, *supra* note 2, at 645. DiMatteo cites P.S. Atiyah who concluded that courts voided these provisions under the fictions of fraud and mistake. Atiyah believes that courts presume unequal results must have been the result of unfair procedures. Atiyah states: “our natural reaction is to believe that something must have gone wrong with the bargaining process. How could a rational person have entered into this contract if he . . . had not been subject to undue pressures, or the like?” *Id.*

25. Hatzis, *supra* note 13, at 385. See also C. Civ. art. 1152 (Fr.) (Note that up until 1975, the French Civil Code did not provide for any judicial scrutiny and modification except under art. 1231 which allowed judicial modification if there had been partial performance—but even the protection of art. 1231 could be stipulated away by the obligor. In 1975, Article 1152 was amended to allow judicial modification both up and down if the sum is “manifestly excessive or ridiculously low.” In 1985, Article 1231 was also amended so that parties could not stipulate away judicial modification for partial performance. For both articles, any agreement to the contrary would be stricken and that part of the contract would be read as if it were never written).

to build both buildings concurrently—it might rationally decide to break its contract with Fred to take the more lucrative contract from Ivan. Of course, Fred would be very upset, he may have planned to relocate his business on August 31st, so now he must find another contractor and also possibly rent space for his employees and office equipment due to the delay in getting a new contractor to build the office. All these expenses will cost Fred \$50,000 in addition to the \$110,000 he must pay to cover the cost of a new contractor on short notice. What is Acme to do? A rational actor (leaving aside reputation costs) would clearly breach this contract if the only penalty that may befall him is \$160,000.<sup>26</sup> Acme has netted about \$40,000, Ivan has a new home, Fred got his office—albeit late—but all parties are happy more or less. Right? It seems that the legal structure under the common law which only allows Fred to recover his expectancy damages would encourage this type of opportunistic behavior by Acme.

Economists would laud this allocation of resources to a higher valued user by arguing that it was efficient for Acme to breach and society as a whole is better off if the user who places a higher value on a good is able to obtain it. Had the civil system been in place, this transaction may very well have never occurred. Had this been a jurisdiction where penalty clauses were enforceable, Fred might have stipulated that in the event of a breach, Acme is to pay Fred \$250,000. Assuming Acme agreed to this, once Ivan approached Acme with his offer of \$200,000, Acme would not be so quick to breach with Fred. Not only would Acme be foregoing the \$100,000 payment from Fred, but it would be liable to pay him \$250,000. Thus the \$200,000 offered by Ivan no longer looks as attractive, and Acme would probably begrudgingly finish the office for Fred while watching his sub-par competitor, Beta Contractors, get Ivan's deal.

On first blush, the outcome under the civil system seems suboptimal; resources are not being used to their maximum ability. But what in fact is *NOT* apparent under the common law system is very important. Presumably, Fred, cognizant of the fact that Acme might walk away at any time should a better deal present itself, has retained a backup contractor for a retainer fee of \$15,000, or has otherwise taken out an insurance policy to protect him against the months a building delay would cost due to seeking cover for a new contractor. He may have even put down a deposit on a new office building so he could move in on short notice should Acme bail out. These transaction costs are not fully appreciated in the efficient breach hypothesis but are very important as an obligee must in some way insure himself from risk *ex ante*, lest he find himself scrambling to find an alternative *ex post*.

Under the civil system, however, where Fred's onerous \$250,000 fee for breach might seem to prevent Acme from allocating its resources to a higher paying buyer, in fact it is possibly a cheaper way for Fred to insure

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26. Figures are not including attorney's fees.



himself against the risk of Acme breaching.<sup>27</sup> Should Acme be approached by Ivan's more attractive offer, Acme would want to renegotiate with Fred to possibly lower the penalty to an acceptable level where Acme and Fred could both share the gains from the better deal and maximize their collective utility. They could agree to lessen the penalty to \$175,000 so both might profit \$25,000 from the deal with Ivan. Fred can then more easily afford cover, Acme has still made a nice profit, and Ivan is happy to have his home built by the best contractor in the city.<sup>28</sup> This prevents the outcome in common law systems, where all the spoils go to the opportunistic Acme.<sup>29</sup>

Under the common law system, the original policy of the court was to protect a party from agreeing to an onerous term, but in a perverse way, this paternalism may have in fact created an exploitative actor who is taking all the gains of a better deal and leaving an innocent party to scramble for substitute performance. The civil system, though admittedly with its own transaction costs—renegotiation could be contentious—seems better at splitting the spoils should a better option come along. Aside from the obvious benefits of increased certainty of performance and cheaper litigation to determine damages under the civil law rule, the reallocation of the proceeds of a superior option should not be understated.

It is beyond the scope of this paper to discuss at length whether enforcement or non-enforcement of these clauses leads to a better societal outcome—this issue has been addressed by a number of scholars—but what is important for the purposes of this paper is to highlight that there is a vigorous debate about the issue, and that the best approach is not apparent.<sup>30</sup> What is clear, though, is that the international economy would be much better off if it adopted a harmonized approach. As it

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27. Presumably, if Fred desired the contract so much so as to mandate an extracompensatory clause payable by Acme, then performance is of special value to Fred. Accordingly, it is also likely that—assuming equal bargaining power—Acme would demand a higher payment price in return for the increased liability they face. This fee is the insurance that Fred is willing to pay Acme rather than to a third party. Seeking third party insurance would probably be more expensive after factoring transaction costs etc.

28. See, generally, Charles J. Goetz & Robert Scott, *Liquidated Damages, Penalties and the Just Compensation Principle: Some notes on an Enforcement Model and a Theory of Efficient Breach*, 77 COLUM. L. REV. 554 (1977) (For an argument that penalty clauses lead to a lessening of transaction costs, Professors Goetz and Scott argue that the performing party is the most efficient insurer. A penalty clause is like insurance that the obligee is willing to pay a premium for. If a penalty clause is not allowed, the obligee will have to take inefficient precautions such as purchase third party insurance).

29. Notions of equity would also support the idea that the opportunistic party is in a way "bad" and this type of behavior should be discouraged if "innocent" parties like Fred don't get to share in the opportunity.

30. For a more thorough discussion, see generally DiMatteo, *supra* note 2; Scott & Goetz, *supra* note 28; Hatzis, *supra* note 13; and Ugo Mattei, *The Comparative Law and Economics of Penalty Clauses in Contracts* 43 AM. J. COMP. L. 427 (1995) (for examples of scholarly material on the relative efficiencies of the civilian v. common law approach).

currently stands, the lack of standardization has led to, and will continue to cause, uncertainty and inefficiency in international commerce.

## II. INTERNATIONAL UNIFICATION?

The idea to create a worldwide standard is not new. The international community has tried for decades to develop some form of a unified treatment on liquidated damages and penalty clauses. In 1979, the United Nations Commission on International Trade Law (UNCITRAL) sought to develop either some form of binding convention, uniform model law, or general conditions to be applied in international trade contracts regarding these types of clauses. It was not the first time that an international body has tried to create a universal standard regarding liquidated damages and penalty clauses.

### A. REGIONAL ATTEMPTS AT UNIFICATION

In 1978, the Committee of Ministers for the Council of Europe published a report on penalty clauses which recommended the member states to take into consideration the principles in their Resolution when the member states' governments prepare new legislation on the subject.<sup>31</sup> Also, in 1973 a regional convention was entered into by the member states of Benelux.<sup>32</sup> UNCITRAL, however, wanted to expand the scope of application beyond limited regional trade organizations, and they

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31. Comm. of Ministers of the Council of Europe, *Penal Clauses in Civil Law* res. (78)3 (Jan. 20, 1978). The principles embodied in the resolution discuss the extent to which these clauses should be enforceable. The text of the resolution is reprinted at the end of this paper in Annex 1. For a detailed analysis of the Resolution, see DiMatteo *supra* note 2, at 654. According to DiMatteo, among the most important points in the Resolution, the issue of judicial adjustment of penal clauses was discussed. He claims the Council adopted language similar to that used in the doctrine of unconscionability. It allows for judicial control over penal clauses "where the penalty is *manifestly excessive*." The Resolution provided a list of factors to determine whether a clause is manifestly excessive. The factors include: "the comparison of the pre-estimated damages with the actual damages suffered, the legitimate interests of the parties including the promisee's non-pecuniary interests, the category of the contract and the circumstances under which it was concluded, in particular the relative social and economic positions of the parties . . . or the fact that the contract was a standard form contract, and whether the breach was in good or bad faith." DiMatteo argues that "manifestly excessive" is synonymous with substantive unconscionability and the factors for reviewing liquidated damages mirror the methods for determining procedural unconscionability such as looking at the relative social and economic position of the parties and the use of standard form contracts.

32. The Interparliamentary Consultative Council of Benelux attempted to create a convention between its member states Belgium, Netherlands, and Luxembourg relating to penal clauses. The convention was done at the Hague on November 26, 1973. The convention did not really address in any significant way the legality of penal clauses, but instead primarily focused its attention to the administrative details of the clauses, such as the statute of limitations on its collection and order of preference for creditors in the event of bankruptcy. Note that as of the time of writing by UNCITRAL to create a worldwide standard in 1979, the Benelux Convention had not yet entered into force. The annex to the Convention, which contains the substantive provisions, is reprinted in Annex 2 at the end of this paper.

wanted to make it so that the end result of their drafting would produce a document that contained teeth. It hoped to establish a world-wide norm that would actually unify the patchwork of national laws and facilitate cross border trade.

In order to understand how the final draft of the proposed convention or model law on liquidated damages and penalty clauses came to be, this paper will chronologically analyze the various drafts and commentary found in the official documents released by UNCITRAL. These documents are the best known evidence of the unfortunately sparse legislative record that described the development of the (ultimately failed) harmonization attempt. The paper will first discuss the reasons UNCITRAL felt this work was necessary and found the current system to be inadequate. It will then try to elucidate why the work ultimately failed by combing through the documentary record—uncovering the points of agreement and, most importantly, those of contention. After an analysis of the legislative record, hopefully the reader will have a better grasp of why the attempt failed and what key issues should be considered and adjusted if, and when, the international community decides to take up this important work once again.

### III. THE UNCITRAL ATTEMPT AT WORLDWIDE UNIFORMITY

#### A. LAYING THE FOUNDATION

Before promulgating such an ambitious rule or law, the commission initially had to inquire into the feasibility and also the necessity of establishing a generally accepted transnational norm—whether it would be a helpful thing to do and whether logistically and ideologically it could be accomplished. After a preliminary investigation, which included the consultation of legal scholars and delegates from many states, it was determined that establishing a uniform law would be beneficial to the furthering of international commerce.<sup>33</sup> In their report from 1979, UNCITRAL discussed several of the reasons why such an undertaking was

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33. *Report of the Secretary-General: liquidated damages and penalty clauses*, *supra* note 5; see also Report of the Secretary-General, *Analysis of Expert Opinions, and Replies to the Secretariat Questionnaire on Liquidated Damages and Penalty Clauses*, [1981] 12 Y.B. Int'l Trade L. Comm'n 44, U.N. Doc. A/CN.9/WG.2/WP.33/ADD.1. (The Secretariat solicited views of selected experts with experience in international contract practices and it also circulated a questionnaire about the relevant issues to the International Chamber of Commerce to distribute to its national committees for comment). The questions asked included:

1. Are provisions inserted in international contracts for the payment of liquidated damages or penalties for total or partial non-performance of contracts (a) often? (b) occasionally? (c) never?
2. Have you encountered difficulties in agreeing upon the insertion of such provisions in international contracts? Please give details.
3. If the answer to question 1 is either (a) or (b), in what kinds of international contracts are such provisions inserted?
4. For what types of non-performance (e.g. delay in performance, failure to meet contract standards) are such provisions usually inserted, and

helpful, if not necessary. It noted that: (1) pre-agreed sums serve a useful purpose because they eliminate the costs of proving loss after breach has occurred; (2) even if damages are awarded, after litigation costs, awards might not be fully compensatory; (3) fixing sums at an amount higher than that which the obligor would normally pay in the event of breach exerts pressure on the obligor to perform on his obligations; and (4) the amount serves to limit the liability of the obligor—if there is a predetermined amount, the obligor can commit himself to less liability than what the law of damages would otherwise prescribe, which allows the obligor to know what his maximum exposure to damages may be.<sup>34</sup>

UNCITRAL went on to describe how the necessity for certainty of liability was especially acute in the context of international trade: “[a] plaintiff who has to establish his loss in a foreign court may incur considerable expense, and also be uncertain as to the extent of his recovery.”<sup>35</sup> The commission reasoned that allowing parties to arrange for this ahead of time would significantly decrease litigation costs and keep foreign parties from having to prove damages in unfamiliar legal systems and in far-away forums. Furthermore, if the pre-agreed sum did in fact coerce performance, this might be desirable since states with planned economies lack the thick markets necessary to find substitute performance should a party breach. In such circumstances, the assurance of performance has a

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what are the special advantages of such provisions for those types of non-performance?

5. Have you encountered any difficulties in the application or enforcement of such provisions in international contracts? Please give details. In particular, have liquidated damages or penalties (a) been declared void? (b) been reduced by Courts or arbitral tribunals?

6. Would the drawing up of a uniform law applicable to international contracts and reducing the difficulties which arise in the use of such provisions be worthwhile?

7. Are there any approaches, other than the drafting of a uniform law, which might reduce the difficulties currently encountered by parties in the use of liquidated damages and penalty clauses (e.g. the drawing up of guidelines to assist parties wishing to use a liquidated damages or penalty clause)?

8. Are there any other observations you wish to make?

34. *Report of the Secretary-General: liquidated damages and penalty clauses*, *supra* note 5, at 40-41; see also *Working Paper submitted to the Working Group on International Contract Practices at its second session*, [1981] 12 Y.B. Int'l Trade Comm'n 39, A/CN.9/WG.2/WP.33 (These working papers expanded upon the reasons that a predetermined sum might be used. They noted that the model rules should cover all types of contracts, because they aren't limited to specific genres of trade, but rather are useful for various circumstances, where, for instance: the breach itself of the main obligation was easy to prove; some industries had developed expected norms for liquidating damages such as set schedules for delay in construction contracts; proof of the actual loss might be costly or difficult; the breach of the main obligation isn't so serious as to make the parties want to end their relationship with each other—but rather a penalty for delay would better ensure an ongoing relationship; there was a need to limit the liability to the obligor in the event of breach; there are instances where the obligee really prefers to receive performance and not damages for breach—for instance if the obligee places idiosyncratic subjective value on performance).

35. *Report of the Secretary-General: liquidated damages and penalty clauses*, *supra* note 5, at 41.

huge benefit.<sup>36</sup>

Of course much of this uncertainty could be resolved without a unified law on damage clauses if the parties stipulate ahead of time what their choice of governing law will be. If for instance, a Chilean supplier of component parts and a French toy manufacturer stipulate that in the event that the Chilean supplier fails to deliver the parts, such breach will be penalized by a sum that exceeds the damages that could conceivably be suffered. If the parties agree to be bound by U.K. law, then they can be fairly certain that any penalty clause they have agreed to will not be enforced by the British Court. Conversely, if they stipulate that the law is to be governed by French law, they can both be fairly certain that the penalty clause will be upheld.<sup>37</sup> The only problem is that parties do not always stipulate what law will govern, or sometimes the choice of law clause is such a contentious issue that raises transaction costs immensely—often leading to the parties entering a stalemate and not agreeing to a choice of law clause at all. It is in these instances that unification of legal systems would be crucial.<sup>38</sup> If parties fail to stipulate ahead of time which law is to prevail, they will not be certain what damages might befall them should one of the parties not perform. Even if the parties think that they will be saved by the default framework that the UN Convention on the Contract for the International Sale of Goods (CISG) provides, they will be disappointed to learn that the CISG does not really address this issue.<sup>39</sup>

CISG article 4(a) defines the scope of the convention, and states that it is *not* “concerned with: (a) the validity of the contract or any of its provisions or of any usage.”<sup>40</sup> Unfortunately for the parties, the CISG leaves a large gap as to the enforceability of the provisions themselves. As such, even though states may be signatories to the CISG, the commercial actors within their borders conducting international trade will not have their liquidated damages and penalty clauses evaluated under this convention. What the parties are then left with is the uncertain and unstandardized hodgepodge of domestic laws, bilateral trade agreements, and individual states’ choice of law rules. Absent some concerted unification on this

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36. Bear in mind that this rationale would have been much more important then than now as Socialist States were far more numerous and wielded much more relative economic power. Even with the exponential growth of trade with China in recent decades, there is probably a much more robust market to obtain cover than in 1970’s Soviet Russia.

37. Barring some other type of circumstance such as partial performance or an agreement for a manifestly excessive sum.

38. “Express selection of a law to govern the contract would mitigate these uncertainties where the *lex fori* recognizes the applicability of the selected law to determine the effect of such clauses, and does not apply its own rules on the basis of public policy. However, there may be no express selection of a law or, even if there is, the *lex fori* may be undetermined.” *Report of the Secretary-General: liquidated damages and penalty clauses*, *supra* note 5, at 46.

39. The CISG is actually a part of all the signatories’ domestic law as it is a binding treaty, but it fails to adequately address the treatment of penalty clauses.

40. United Nations Convention on Contracts for the International Sale of Goods (CISG), art. 4(a) (1980).

topic, the parties will be forced to concur upon the governing law and its accompanying conflicts treatment or face uncertainty as to the legal effect of their agreed sum.

UNCITRAL concluded its 1979 report with the observation that policy differences needed to be reconciled between the common and civil law countries before any sort of unification was possible. The commission noted the difficulty of this task would be by highlighting that the policy grounds, which underlie each system's rule, are based upon cherished legal ideologies. They noted that the "[d]ifferences as to the grounds of public policy which invalidate penalty clauses would be difficult to harmonize, since the grounds adopted by each legal system would be based on *values of special importance* to it."<sup>41</sup>

The commission did not attempt to mask its agenda of making penalty clauses enforceable in international trade contracts. UNCITRAL seems to have clearly favored their enforceability, and it was keen to chip away at the common law's reticence to enforce these clauses. Despite the ideological divide between the two legal traditions, the commission was optimistic that the two systems could still overcome their differences. It noted that since prearranged sums are not *per se* illegal in common law systems—if the commission was able to apply some restrictions to the availability of these clauses, it might be able to appease the concerns of common law courts. UNCITRAL hypothesized that a way to get common law countries on board would be to qualify their use by possibly "restricting the application of the rules to international contracts, continuing to apply existing rules protecting a weaker contracting party against fraud and coercion and, in particular, making the unified rules applicable only upon express selection by the parties."<sup>42</sup>

## B. ANALYZING THE PROCESS

Though it may be a bit tedious, it seems the best way to elucidate the major snags to international unification is to go through the drafting process of the model rules themselves to observe how the parties involved framed the issues and how they perceived the potential hurdles—and solutions to such hurdles. Through a chronological analysis, it can be seen how the rules were drafted, discussed, and ultimately distilled to the language that actually appeared in the draft UN convention. By looking at its development, one can understand which issues were the most contentious and hopefully one can identify those concerns that have prevented uniformity from being achieved nearly three decades later.<sup>43</sup>

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41. *Report of the Secretary-General: liquidated damages and penalty clauses*, *supra* note 5, at 47 (emphasis added). It is not clear if the differing legal systems actually hold dissimilar *values* or whether they simply hold dear to different *techniques* to protect their similar values.

42. *Id.*

43. It is a difficult question to answer exactly why there is no unified standard roughly thirty years after UNCITRAL determined to address this issue in 1979. Unfortunately, there is little on the record between the parties who attempted to adopt a

Subsequent to the initial statement by UNCITRAL in 1979 that it wished to establish a uniform international standard, meetings were held by a working group to try to iron out the specifics of what would hopefully be either a treaty or, at a minimum, a model law that would actually lead to adoption by the individual member states' legislatures. In the following pages there will be a breakdown of the points of agreement and disagreement of the working group. These will hopefully frame the main issues of concern and disagreement between the scholars and member states involved in the drafting.

#### IV. UNCITRAL DRAFTING SESSIONS: THE ISSUES ARE DEBATED

##### A. FEBRUARY 1981 WORKING GROUP FINDINGS

##### 1. *Points of Agreement of the Working Group*

In a working Paper by the Working Group on International Contract Practices from April 1981, UNCITRAL first tried to establish the scope of the finished document.<sup>44</sup> They determined that it was crucial to treat both penal clauses and liquidated damages similarly. Often it was difficult to determine the purpose of the clause until after the fact when damages were to be determined. The working group reasoned that:

in many cases, the sum of money to be paid on breach was not described in the contract as either penal or compensatory, and determining whether the sum fell into one or the other category would often be difficult, and sometimes impossible when parties intended the sum to be both penal and compensatory. Indeed parties do not always clearly distinguish the two concepts.<sup>45</sup>

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convention on this matter, and there is also essentially no scholarly commentary outside of the UN documents themselves discussing why the UNCITRAL's attempt at unification was not a success. What is known from the little documentary evidence is that from the get-go, there was not simply a conflict between common law countries and civil countries. It was not simply a pitting against the ideologies; there were many states from within civil systems that held widely divergent views as to how to best unify the system. Most countries focused on the practical problems that came along with instituting such an ambitious international agreement. The issues and concerns raised by the countries ran the gamut from those States that considered the lack of uniformity to be such a miniscule problem that it was not worth addressing to other nations seeing it as potentially such a divisive issue that to try to resolve it would be futile. What is clear however is that it was seen as an important enough problem in which to invest significant resources and time, but to date, there has been no final solution. This paper will discuss many of these issues in further detail in the analysis that follows.

44. The Working Group on International Contract Practices was composed of the States' members of the Commission: Austria, Czechoslovakia, France, Ghana, Guatemala, Hungary, India, Japan, Kenya, Philippines, Sierra Leone, Trinidad and Tobago, USSR, United Kingdom of Great Britain and Northern Ireland, and the United States of America. See *Report of the Working Group on International Contract Practices on the work of its second session*, [1981] 12 Y.B. Int'l Trade Comm'n 25, U.N. Doc. A/CN.9/197.

45. *Working Paper submitted to the Working Group on International Contract Practices at its second session*, [1981] 12 Y.B. Int'l Trade Comm'n 32, U.N. Doc. A/CN.9/

They further determined that the scope of the model should not cover all types of prearranged sums—but it should only cover agreed sums that were categorized as liquidated damages or penalty clauses. The commission noted that there are 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 the focus of UNCITRAL's attention. Such clauses were, for example, a termination fee or the acceleration of payments upon nonperformance. The commission viewed these not to be an agreement for a sum upon breach, but rather the price payable for the exercise of an option—for instance the right to walk away from the contract. They lacked the same requirement that the obligor be tied to commit a primary obligation before the sum is to be paid.<sup>46</sup>

The working group was also in full agreement that the stipulated sum would only be enforceable if the obligor was actually liable for his failure to perform. This essentially meant that the obligee could not demand payment if the breach was due to *force majeure*, or other instances that typically exculpate nonperforming parties from their obligations under contract law. The working group believed the scope of liability should not extend to “circumstances constituting *casus fortuitus*, and acts imputable to the promisee leading to the promisor's inability to perform the main obligation.”<sup>47</sup> The working group also had little conflict over the notion that if the obligee seeks to enforce the agreed sum, he was no longer entitled to enforce the original obligation. In later drafts the working group clarified this principle so that if a penalty or liquidated damages clause was included for a *delay* in performance, the obligor could enforce both the sum and the performance. They reasoned that the purpose of the fee for delay was to strongly encourage timely performance, but even in the event of delay, the obligee still desired delivery of the object of the original contract.

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WG.2/WP.33. [hereinafter “*Working Paper*”] Sometimes parties purposefully leave their intentions ambiguous because they would like the agreed sum to play both roles depending on the circumstances of the breach. The working group gave the example of a contract for sale of pneumatic plant by a Western European enterprise to an Asian Enterprise where the agreement for delay read “[w]ith the exception of force majeure causes involving extension of period as set forth . . . if there should be any delay in FOB delivery . . . a *compensation of delay* will be withheld from the supplier's ten percent balance.” At times parties seek compensation for breach, but it may be feared that the pre-estimate will be deemed *ex post* to exceed actual damages. In those instances the obligee may want it to be a penalty. The working group also gave an example of such a situation in a contract for sale of equipment between a North American enterprise to a foreign enterprise: “In the event the said liquidated damages are held by a Court of competent jurisdiction to be unenforceable for any reason whatsoever, it is hereby agreed and expressly declared that the aforesaid amounts shall be penalties.” *Id.*

46. “Such a clause deviates from the traditional conception of a liquidated damages clause as constituting an accessory obligation.” *Id.* at 33 n.22.

47. *Id.* at 34.



The working group also tentatively concluded that it needed to agree to the definition of the *type* of contract to be enforced. Some characterization on its international nature needed to be established. They discussed, and the finished product actually reflected, a borrowing of the language from the CISG.<sup>48</sup> They thought the way that the CISG determined whether a contract was international was simple and could be applied to a variety of contracts that the proposed rules would govern.<sup>49</sup> It was also believed that it would expand the scope of CISG coverage if the same terms were used. UNCITRAL believed this would help integrate a more robust coverage of international uniformity on the important issue of cross border contracting generally.<sup>50</sup>

## 2. *Points of Disagreement of the Working Party*

One of the major points of disagreement between the members of the working group was the ability to adjust the sum either up or down, depending on the circumstances. Of great concern was whether the agreed sum was the absolute ceiling to be imposed for damages. Some members felt that it should be since the entire purpose of the clause is to provide some certainty to the obligor so he knows what the extent of his liability may be. They thought it would be unfair for the parties to freely enter into a liquidated damages sum only to later have the obligee claim his actual damages exceeded this amount. Other members believed that the presumption should be that if breach has occurred, the obligee is only entitled to the agreed sum, *unless* he then satisfies the burden to prove his damages *actually exceeded* the agreed sum. The proponents of this view believed that the obligee was entitled to full recovery and if actual damages were unanticipated, he should not bear this burden if he is capable of proving the actual amount in court.<sup>51</sup>

Also, of great disagreement was the *downward* adjustment of penalty clauses. It has been the standard in systems based upon the Napoleonic Code, such as the French Code that judges have the discretion to adjust a penalty clause downward if it is excessive to the amount of harm actually

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48. See CISG, *supra* note 40, art. 1 (for a description of the international character of a contract—the UNCITRAL final draft copied this nearly verbatim).

49. See *Working Paper*, *supra* note 45, at 39.

50. This specific point was later raised by the Austrian delegate in a subsequent report.

51. Not all civil law countries' domestic law is in harmony in this respect. For instance some nations do not require a judicial modification of the clause upward in order to recompense an aggrieved party who has agreed to too low a sum—the obligee need only prove his excess damages and he will get them. See, e.g., OR art. 161 (Switz.) ("If the damages suffered exceeds the amount of the penalty, the obligee may recover the excess only in so far as he proves fault"). Compare this approach with that of the French: Under the French Civil Code Article 1152 (prior to 1975), even if obligee could prove excess damages, he was barred from recovery of this proven amount. Civ. CODE art. 1152 (Fr.). Following the 1975 amendment, the court is authorized to increase the amount of the agreed amount if it is "ridiculously small." Theoretically this still may not amount to the actual damages suffered or even proved, but one may conclude that the French court will bring the amount closely in line with the actual damages suffered by the obligee.

suffered.<sup>52</sup> The problem is that, though adjustment was almost universally acknowledged as a necessity to protect against oppressive bargaining, allowing judges to make this type of modification re-injects uncertainty into the process. Parties are then unable to truly anticipate their potential liabilities or potential recompense if a judge can substantially adjust the sum.

The members of the working group had very divergent views on downward adjustment; at least four alternatives of the wording of the judicial modification clause were formulated which reflected the varying levels of mistrust of judges, or at least a strong reluctance to not have absolute certainty.<sup>53</sup> It was, however, concluded that despite *Variation C*, which called for no judicial adjustment *whatsoever*, the other three formulations all essentially agreed that some sort of downward modification would be desirable. This would “make the sum mainly compensatory, although the reduced sum may to a minor extent exceed the compensatory damages which a national system might award.”<sup>54</sup>

#### B. MARCH 1981 WORKING GROUP FINDINGS

Before the working group took up the adjustability issue again, the Secretary General issued a report that gave a synopsis of the responses it received from the national committees of the International Chamber of Commerce (ICC). The ICC had circulated to member states a questionnaire to obtain their feedback on various issues relating to these clauses. It is not clear which countries were solicited, but the only countries to respond to the draft at the time were Belgium, France, Finland, Germany, India, Israel, Italy, Japan, Norway, Korea, Sweden, and Turkey. It was

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52. See Civ. CODE art. 1152 (Fr.) (note that this downward adjustment has only been in effect since the 1975 amendment). See also GEROLD HERRMANN, THE TRANSNATIONAL LAW OF INTERNATIONAL COMMERCIAL TRANSACTIONS: THE CONTRIBUTION OF UNCITRAL TO THE DEVELOPMENT OF INTERNATIONAL TRADE LAW 43 (Norbert Horn Ed., 1982) (stating that the reduction of an agreed sum was a “controversial question”).

53. See *Working Paper*, *supra* note 45, at 38 (The four variants were:

*Variant A*: “An agreement stipulating a sum payable on breach of the contract shall be void if it is grossly excessive in relationship to both (a) the harm that could reasonably have been anticipated from the breach, and (b) the actual harm caused thereby. The foregoing relationships are not excessive to the extent that such harm cannot be precisely predicted or established.”

*Variant B*: “The sum stipulated may be reduced by the court when it is manifestly excessive, but only where such sum did not constitute a genuine pre-estimate by the parties of the damages likely to be suffered by the promisee.”

*Variant C*: This was a provision to the effect that a court should not have the power AT ALL to modify the sum stipulated.

*Variant D*: “Any penalty clause the amount of which, at the time when it was stipulated, was manifestly excessive in relation to the damages which could be foreseen as the consequence of non-fulfillment of the obligation, is deemed not to have been written.”).

54. *Id.* at 39.

noted that several opinions were also received from legal experts.<sup>55</sup>

### 1. *The States' Feedback*

The questionnaire first tried to establish how frequently these types of provisions were used, and most of the countries responded that their use was extremely recurrent in international contracts.<sup>56</sup> Most countries also agreed that the majority of contracting parties acknowledged that the use of an agreed sum upon damages was very useful, but there were often disagreements as to its contents. The responding States and experts went on to say that the use of these provisions was found in all types of international trade contracts—they were not limited to only certain genres of contracts.<sup>57</sup>

After establishing some more baseline questions as to the frequency and use of these provisions, the questionnaire then proceeded to ask a more divisive issue: "*Would the drawing up of a uniform law applicable to international contracts and reducing the difficulties which arise in the use of such provisions be worthwhile?*" The proponents of drawing up a uniform law cited its virtues in reducing the difficulties caused by the differences in national laws on liquidated damages and penalties. They thought it would: reduce negotiation costs between contracting parties; at a minimum, provide guidelines that could be followed by parties should a convention not be agreed to; and provide for better remedies to the party entitled to liquidated damages or the penalty.<sup>58</sup>

The opponents, however, verbalized concerns which to this day may be the types of issues that have kept unification from ever occurring. They explained that: (a) States are hesitant to accept uniform laws in the field of contract generally, and "in particular States which had national laws to check abuses of liquidated damages and penalties would be reluctant to exclude international commercial contracts from their sphere of application;" (b) the difficulties in this area of contract law were practical in nature and were peculiar to each transaction so they could not be resolved by a uniform law; and (c) a uniform law's text would necessarily be too vague to serve much good.<sup>59</sup> The reason provided in section (a) seems quite telling; presumably this was referring to common law countries' reticence to have two standards of legal enforcement. The cynical

55. Unfortunately, again the official documentary record here is sparse. There is little written beyond these limited facts.

56. Report of the Secretary-General, *Analysis of Expert Opinions, and Replies to the Secretariat Questionnaire on Liquidated Damages and Penalty Clauses*, *supra* note 33, at 44. For a reproduction of the questions asked, *see id.*

57. The respondents said the types of contracts that they used were often contracts for supply of goods, manufacturing and installation of plant machinery, construction contracts, joint ventures, and long term supply of services. For loan agreements, the penalty was often an increased rate of interest. *Analysis of Expert Opinions, and Replies to the Secretariat Questionnaire on Liquidated Damages and Penalty Clauses*, *supra* note 33, at 45.

58. *Id.* ¶ 13.

59. *Id.* ¶ 15. (emphasis added).

member nations that responded to the questionnaire seemed to think common law countries would be unwilling to allow their judges to enforce clauses that would have been against public policy, *but for* their international status. Something that is probably worth noting is that not one of the member countries that responded to the questionnaire was from the common law tradition.

Lastly, the questionnaire asked if the parties could offer any alternatives, other than a uniform law, that might reduce the difficulties of using these provisions in international transactions. The respondents came up with two possible alternatives: (a) to draw up standard contracts or general conditions which would aid parties in developing their contracts based on a model; or (b) to create guidelines with an analysis and solution to the problems encountered. Those who were in favor of a model law or a convention saw these two alternatives as a waste of time—no certainty would be achieved which was the whole purpose of this international effort.

### C. NOVEMBER 1981 WORKING GROUP FINDINGS

#### 1. *Discussion of the Prior Regional Attempts*

In the commission's fifteenth session, the Secretary General's report began by detailing the two previous efforts at unification, which were both only regional. It discussed how the Council of Europe formulated a set of principles in Resolution (78) 3 "on penal clauses in civil law." This resolution "recommend[ed] to member Governments that they take the principles into consideration when preparing new legislation on the subject, and consider the extent to which the principles can be applied, subject to any necessary modifications, to any other clauses which have the same aim or effect as penal clauses."<sup>60</sup> The commission also described briefly the Benelux Convention that was entered into between Belgium, the Netherlands and Luxembourg in 1973, which compelled member states to adopt into their national legislation, common treatment of certain provisions set forth in the convention.<sup>61</sup>

It is important to bear in mind that these two prior attempts were both limited to regional trade agreements and were limited to countries within the same legal tradition—the civil law. It is no surprise then that the UN Commission's world-wide goal would be a much more difficult task to achieve than the mere regional integration of countries with very similar legal traditions. It does not seem that the differences between Belgium, Holland, and Luxembourg would be substantial enough to freeze an in-

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60. Report of the Secretary-General, *Report of the Secretary-General: text of draft uniform rules on liquidated damages and penalty clauses, together with commentary thereon*, [1982] 13 Y.B. Int'l Trade Comm'n 27, U.N. Doc. A/CN.9/218 [hereinafter *The Rule*]. The entire text of Resolution (78)3 is reprinted at the end of this paper in Annex 1.

61. At the time of this Secretary General report, the Benelux Convention had not entered into force. The text of the Benelux Convention is reprinted at the end of this paper in Annex 2.

ternational agreement. Presumably, since their domestic treatment on this subject was already in fairly close conformity, this convention—which at the time of the UN draft had not come into effect—did little but codify what essentially already existed, with minor adjustments.<sup>62</sup>

A much more arduous task would be to get Britain's and the United States' legal systems in line with the rest of the world on this subject. Without these two countries—and to a lesser extent Canada, South Africa, and Australia—in the fold, major economic players would be excluded from this important work. The desire to have transactions between civil law economic actors and U.S./U.K. parties would have been a very strong motivation to get this convention accepted by the common law countries.<sup>63</sup> The problem, though, was that these countries held very dearly to the public policy and efficient breach reasons for not upholding these clauses.<sup>64</sup> Integrating these states into a uniform framework would prove to be an uphill battle.

## 2. *Drafting of the Unified Rules*

During this fifteenth session, UNCITRAL decided that until the form of the finished product was finalized, the working group would continue to work on a draft and call it the "Rules." Until it was determined that the ultimate document would be a binding convention, a model law or merely general conditions, they proceeded by developing these Rules. The working group wanted to give as much effect as possible to international trade practice as it currently existed. As such, it was cognizant that the contracting parties shouldn't be tied into the default Rules. It was agreed that parties should have the ability to deviate from the provisions should they so choose. The only thing that the parties could not derogate from was the defining scope of the Rules and most importantly, the ability of a court or arbitral tribunal to adjust an oppressive agreement.<sup>65</sup>

UNCITRAL then set forth a complete draft of the Rules in both a version that could be adopted as a model law or a convention. They noted that if a convention was the route to be taken, additional standardized language would need to be included that would allow it to be entered into force. And if a model law was the end result, different language

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62. Furthermore, the content of the Benelux Convention seems far more administrative than substantive. It doesn't discuss issues like the actual *enforceability* of the clauses. The convention concerns itself mostly with minor details like harmonizing a statute of limitations for recovery of a penal sum.

63. Also, the fact that many parties select U.S. or U.K. law as the governing law in their contracts—even if neither party is from those states—makes harmonization by these major legal systems very important.

64. Though both of these rationales might have been standing in the way, from the circumstantial evidence, it appears that the public policy reasons were the more offensive to common law countries. In no recorded discussions was efficient breach really brought forth as a reason that adoption would be difficult.

65. It was rightfully surmised that the sole purpose of a court adjusting a penalty clause would be to protect against an unfair bargain. If the stronger party could simply put in an oppressive penalty and then state that the sum is not adjustable by a tribunal, then a patently unfair result would occur.

needed to be included to enable the adopting states to integrate it into their own national legislation. This language needed to provide for flexibility so that it could be “workable within the legal system of that state. The legislature of the State adopting the law would be the appropriate body to decide on what provisions are necessary.”<sup>66</sup>

### 3. *The Draft Articles of the Rules*

The commission decided at this time to put forth a draft of the Rules that would later be commented upon in future sessions. At its outset, this draft established what types of parties would be covered. *Draft Article A* concluded that, for the purposes of the Rules, neither the nationality nor the commercial character of the parties should be considered in determining the applicability of the Rules.<sup>67</sup> The commentary noted that some legal systems treat the classification of the parties as relevant to the type of law to be applied. For instance some countries will apply different laws to civil versus commercial actors, whereas other states do not make this classification.<sup>68</sup> The commission wanted the Rules to be applied uniformly so they determined this distinction should be irrelevant.<sup>69</sup>

*Draft Article B* resolved that if a party has more than one place of business, then the place of business that is most closely related to the

66. The Rule, *supra* note 60, at 28.

67. Draft Article A gives slightly different proposed language for a Convention or a Model Law, whichever is to be adopted.

- The language for paragraph 1 of a *Convention* reads: “This convention applies to contracts in which the parties have agreed [in writing] that, upon a total or partial failure of performance by a party (the obligor), another party (the obligee) is entitled to recover, or to forfeit an agreed sum of money when, at the time of the conclusion of the contract, the parties have their places of business in different Contracting States.”
- The language for paragraph 1 of a *Model Law* reads: “This law applies to contract in which the parties have agreed [in writing] that, upon a total or partial failure of performance by a party (the obligor), another party (the obligee) is entitled to recover, or to forfeit an agreed sum of money: (a) When at the time of the conclusion of the contract, the parties have their places of business in different States, and (b) When the rules of private international law lead to the application of the law of (the State adopting the Model Law).”
- The language in paragraphs 2 and 3 applies to either a *Convention* or a *Model Law*. It reads: (2) “The fact that the parties have their place of business in different states is to be disregarded whenever this fact does not appear either from the contract or from any dealings between, or from information disclosed by, the parties at any time before or at the conclusion of the contract.” (3) “Neither the nationality of the parties nor the civil or commercial character of the parties or of the contract is to be taken into consideration in determining the application of this (Convention) (law).”

The Rule, *supra* note 60, at 28-29.

68. The Rule, *supra* note 60, at 31. An example of a country which supplies different levels of legal protections depending on the commercial nature of the actors is Germany. German Commercial Code § 348 says “A contractual penalty, which a merchant promised in the course of carrying on his trade, may not be reduced by reason of the provisions of §343 of the Civil Code.” Handelsgesetzbuch [HGB] [Commercial Code], § 348 (translation from THE GERMAN COMMERCIAL CODE 752 (Simon L. Goren trans., 2d ed. Oct. 28, 1994)).

69. The Rule, *supra* note 60, at 31. This closely mirrors the language in CISG art. 1(3).

contract and its performance is the relevant location.<sup>70</sup> The commission further stipulated that if the party has no place of business, then reference is to be made to his "habitual residence." The commentary noted that the place of incorporation or its main place of business is not the relevant inquiry, but rather where the place is that "has the closest relationship to the contract and its performance."<sup>71</sup> The commission was aware that the parties contemplated for this program would generally be sophisticated "businessmen who have recognized places of business," but it still felt nonetheless that consideration should be given to the occasional actor who does not have an established place of business but would otherwise fall under the ambit of these Rules. They determined that such actors' habitual residence should thus be considered.<sup>72</sup>

*Draft Article C* is very important to analyze.<sup>73</sup> The commission surmised that one of the major roadblocks in obtaining broad acceptance and ratification would be the domestic reluctance of countries who thought penalty clauses violated public policy because, through inequitable bargains, oppressive clauses were formed. The Commission therefore determined that the Rules should only apply to sophisticated actors so as to prevent this perceived oppression. Presumably, if the only parties who qualified under this convention or model law were knowledgeable commercial players, then the courts wouldn't as frequently need to analyze issues of unconscionability *ex post*.<sup>74</sup> *Article C* stipulated that this convention or law would *not* apply to contracts concerning consumer or personal goods, or anything to be used for the household purposes of a party. This carve-out was made so that each country would be free to use its domestic laws to protect weaker parties—it was a conscious effort made to ensure that "no conflict would arise with the Rules."<sup>75</sup> This consumer goods carve-out was, however, qualified with the provision that if the other party, at the conclusion of the contract, did not know, and had no reason to know that the wares were to be used for household purposes,

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70. Draft Article B reads: "For the purposes of this (Convention) (law): (1) If a party has more than one place of business, the place of business is that which has the closest relationship to the contract and its performance, having regard to the circumstances known to or contemplated by the parties at any time before or at the conclusion of the contract. (2) If a party does not have a place of business, reference is to be made to his habitual residence." The Rule, *supra* note 60, at 29.

71. The Rule, *supra* note 60, at 32. This language was copied verbatim from CISG article 10(a).

72. The Rule, *supra* note 60, at 32. This appears to also have been copied from CISG art. 10(b).

73. Draft Article C reads: "This (convention) (law) does not apply to contracts concerning goods, other property or services which are to be supplied for the personal, family or household purposes of a party, unless the other party, at any time before or at the conclusion of the contract, neither knew nor ought to have known the contract was concluded for such a purpose." The Rule, *supra* note 60, at 29.

74. The Rule, *supra* note 60, at 32.

75. *Id.*

then the Rules would still be applicable.<sup>76</sup> This caveat was meant to ensure that a promisee, who could not have known the use of the contracted for supplies was to be for personal purposes, could rely on the provisions of the Rules to ensure the liquidated damage and penalty clauses would be enforced.

*Draft Article D* was simply a reiteration of the earlier provision that passed without much debate that the obligor had to pay the agreed sum only if he was actually liable for non-performance.<sup>77</sup> This prevented payment in instances of the usual exculpatory situations—*force majeure*, absence of fault, etc. These determinations were to be made in accordance with the applicable domestic law.<sup>78</sup> One unfortunate consequence of the drafting of *Article D* is that it seems to open up the issue of proof of fault, which the obligee probably sought to avoid by demanding a prearranged sum to begin with.<sup>79</sup>

*Draft Article E* allowed for recovery of the sum and compulsion of performance only in instances where the sum was stipulated for *delay* in performance.<sup>80</sup> In all other instances of breach, the obligee could only choose performance *or* payment of the sum. This article however did allow for the parties to derogate from this should they choose to by indicating that “[t]he rules set forth above shall not prejudice any contrary agreement made by the parties.”<sup>81</sup> *Article E* essentially concerned itself with the problem of overcompensating the obligee. It was determined that to enforce both the obligation and the payment would in many instances lead to unjust enrichment for the obligee. However, as described earlier, the commission felt that if the sum was stipulated to for the purpose of delay, then it would make sense to have both performance and

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76. Note this language deviates from CISG art. 2 which does not apply to household goods unless the “seller” didn’t know nor had reason to know it was for that purpose. *Draft Article C* applies to either party.

77. *Draft Article D* reads: “Unless the parties have agreed otherwise, the obligee is not entitled to recover or to forfeit the agreed sum if the obligor is not liable for the failure of performance.” The Rule, *supra* note 60, at 29.

78. Which in some instances may be the CISG since it is a binding treaty that becomes part of the signatory’s domestic law.

79. This once again raises the issue of the balance between fairness and certainty. If the obligor is not at fault, it seems unfair to place liability on him to pay the sum, but the clear result of the draft language is that the obligee, which has relied on the prearranged sum to protect him if there is nonperformance, now must bear the loss himself.

80. *Draft Article E* reads:

(1) Where the agreed sum is to be recoverable or forfeited on delay in performance of the obligation, the obligee is entitled to both performance of the obligation and the agreed sum. (2) Where the agreed sum is to be recoverable or forfeited on non-performance or defective performance other than delay, the obligee is entitled either to performance, or to recover or forfeit the agreed sum, unless the agreed sum cannot reasonably be regarded as a substitute for performance. (3) The rules set forth above shall not prejudice any contrary agreement made by the parties.

The Rule, *supra* note 60, at 29.

81. *Id.*



compensation of the sum.<sup>82</sup>

*Draft Article F* speaks to the ability of an obligee to obtain damages in excess of the stipulated amount.<sup>83</sup> As described in the earlier Working Group documents discussed above, this was an issue that concerned some commentators because it allowed for fairness at the expense of certainty. *Article F* entitles the obligee to recover the sum and states that he "is entitled to damages to the extent of the loss not covered by the agreed sum, but only if he can prove that his loss grossly exceeds the agreed sum."<sup>84</sup> The commentary spoke of the tension between sureness and equity—that it is useful for the obligee to know his potential liabilities, but a "restriction would cause hardship to the obligee if his actual loss exceeds the agreed sum."<sup>85</sup> The provision was deemed to be a compromise between these two poles—it allowed recovery after the obligee meets his burden of proof AND such loss is grossly in excess of damage. It appears then that there is a *de minimis* threshold that the drafters wanted so that courts would not be bogged down with the same sort of squabbles the model Rules aimed to avoid in the first place.<sup>86</sup> It is also important to note that the parties may expressly provide that the agreed sum is an absolute cap—in these instances the obligor could know for certain his potential liabilities, but the default provision will not guarantee this certainty unless the parties make it explicit.<sup>87</sup>

*Draft Article G* is also concerned with the tension between justice and certainty.<sup>88</sup> This provision, however, does not speak to whether a party can obtain sums in *excess* of the agreed amount, but whether courts or tribunals can *reduce* an agreed amount. It is fairly well established in many civilian systems, and even in the UNIDROIT principles, that in the event that an agreed sum significantly penalizes the breaching party, the

82. *Id.* at 33. For an earlier discussion the issue of delay, see *supra* page 21 of this paper.

83. Draft Article F reads:

Unless the parties have agreed otherwise, if a failure of performance in respect of which the parties have agreed that a sum of money is to be recoverable or forfeited occurs, the obligee is entitled, in respect of the failure, to recover or forfeit the sum, and is entitled to damages to the extent of the loss not covered by the agreed sum, but only if he can prove that his loss grossly exceeds the agreed sum.

The Rule, *supra* note 60, at 29.

84. *Id.*

85. *Id.* at 34. Note the commentary in the quoted passage did not reference "grossly exceeds", but just "exceeds." It seems that the commentator was concerned that any excess damage would be unfair, but it would be administratively impossible to determine exact harm, so the language of gross excess was ultimately employed.

86. Such squabbles would be, for instance, determining the minute details of damages. Unless the obligee *clearly* was undercompensated, then a court would not involve itself in the matter.

87. The Rule, *supra* note 60, at 34 n.39.

88. Draft Article G reads:

(1) The agreed sum shall not be reduced by a court or arbitral tribunal.  
(2) However, the agreed sum may be reduced if it is shown to be grossly disproportionate in relation to the loss that has been suffered by the obligee, and if the agreed sum cannot reasonably be regarded as a genuine pre-estimate by the parties of the loss likely to be suffered by the obligee.

court has some discretion to modify the award downward.<sup>89</sup> *Article G* of the Rules boldly starts by stating in subsection (1): “[t]he agreed sum shall not be reduced by a court or arbitral tribunal.” It then immediately qualifies this in subsection (2) by saying:

[h]owever, the agreed sum may be reduced if it is shown to be *grossly disproportionate* in relation to the loss that has been suffered by the obligee, and if the agreed sum cannot be reasonably regarded as a genuine pre-estimate by the parties of the loss likely to be suffered by the obligee.<sup>90</sup>

#### 4. Editorial Comment on Draft Article G

The interesting thing to note about *Draft Article G* quoted above is that it seems like the commission is making the court analyze the damages looking both backward and forward. Essentially, this means that the pre-estimate will be evaluated after the fact by the court with attention as to what the actual damage was. Additionally, in a somewhat strange way, the commission is requiring that the obligee must have actually made a bona fide or “genuine pre-estimate” of loss that might be suffered. This judicial analysis of the parties’ subjective intent seems to contravene the whole premise of the proposed convention—to give legal effect to the will of the parties as evidenced in their writing. It should be irrelevant whether the parties intended the clause to be coercive, what should only matter, as far as the court is concerned, is whether enforcing the penalty would result in an outcome that contravenes public policy. Only then should the award be modified. It is the opinion of this author that the *ex post* analysis of the parties’ subjective intent *ex ante* does little to serve the interest of equity. The commentary to *Article G* of the rules says this second limitation—that it must be a “genuine pre-estimate” of the potential loss of the obligee—is “justified by the view that agreements aiming solely at the compensation for loss caused by failure to perform deserve to be encouraged.”<sup>91</sup>

This author recognizes the philosophical and practical reasons the drafters wanted to encourage good faith pre-estimates of damage, and discourage provisions that were known to be in excess of possible damages, but it does not seem that this second prong does anything to promote equity—it only prevents obligees who place high subjective value on performance or who wish to insure themselves against breach through paying a premium from actually inserting these clauses.<sup>92</sup> It seems that if an obligee puts in a clause that he knows to exceed potential damage by,

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89. See, e.g., CIV. CODE art. 1152 (Fr.); BGB §343 (F.R.G.); OR art. 163 (Switz.); and UNIDROIT principles §7.4.13(2).

90. The Rule, *supra* note 60, at 29 (emphasis added).

91. The Rule, *supra* note 60.

92. This may, however, have been an attempt to pacify common law judges by making the clauses appear to be more of a good faith pre-estimate of damages, and thus not void under public policy considerations. The final iteration of the Rules does not contain this language—this absence is later discussed in further detail.

say ten percent, and then the obligor does breach, the court should enforce this because ten percent is not so excessive as to contravene good morals. Under the *Draft Article G*, this would be unenforceable because the obligee knew it would be in excess of the potential harm he might suffer. Perversely, however, if this same liquidated damages clause was inserted by the same obligee, but in this instance he actually thought the sum roughly mirrored his potential losses, but in actuality the sum ended up being too high by ten percent, the court would enforce it. The obligor would not be harmed anymore and the obligee would no longer be enriched, but strangely the drafters seem to demand a good faith requirement of sorts.<sup>93</sup> This author believes this second requirement adds little to the protection of weak parties. A modification based solely on a backwards analysis of harm actually suffered satisfactorily protects weaker parties.<sup>94</sup>

#### D. MAY AND JUNE 1982 GOVERNMENT COMMENTARY

Following the creation of the 1981 Draft Rules previously discussed, these Rules were then circulated to "interested international organizations and *all* Governments for their comments."<sup>95</sup> In May 1982, responses were received from Austria, Argentina, Canada, Chile, Cyprus, Japan, Philippines, Poland, Republic of Korea, Spain, Sweden, Turkey, Venezuela, and the Soviet Union. By June of 1982, an additional four countries had responded: the Federal Republic of Germany, Hungary, the Netherlands, and Norway.<sup>96</sup> It appears that the information was circulated to *all* UN Member States, but the response was rather lackluster. Only eighteen countries ever responded, and of the countries that did, the only true common law country was Canada.<sup>97</sup> The commentary of the

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93. It may be that the good faith requirement is more of a symbolic safeguard than a practical one as it is difficult to prove a lack of good faith. The drafters may have simply wished to encourage good faith despite their understanding that its absence could rarely be proved. The requirement of good faith dealing is an important obligation in civil law countries—most, if not all have a good faith requirement codified into law, which must be applied in all contractual dealings. *See, generally*, CIV. CODE art. 1134 (Fr.); BGB § 242 (F.R.G.); a good faith requirement is even found in U.C.C § 1-304.

94. It should be noted that in the final draft of the Rules, the language requiring the parties to make making a genuine pre-estimate of the damages suffered was conspicuously missing. A more thorough discussion of this important absence is described at length below.

95. *Draft uniform rules on liquidated damages and penalty clauses: analysis of the responses of Governments and international organizations*, [1982] 13 Y.B. Int'l Trade Comm'n 35, U.N. Doc. A/CN.9/219 (emphasis added) [hereinafter "*Draft Expert Analysis*"].

96. Responses were also received from the following international organizations: United Nations Conference on Trade and Development (UNCTAD) and the United Nations Industrial Development Organization (UNIDO).

97. The Philippines might also be considered a common law country. *See In Re Shoop*, 41 Phil. 213 (1920). Noteworthy is that there were numerous common law nations in the working group, including Great Britain and the United States; it seems surprising that these common law juggernauts would not make any comment or bother to respond to the questionnaire, when presumably, they had the

countries did however shed some important light on what kinds of issues were foreseen to be potential obstructions to widespread acceptance. The responding states had differing views as to what the most appropriate form the uniform Rules should take.<sup>98</sup>

### 1. *Those in Favor of a Convention*

Austria, Argentina, Chile, Cyprus, the Netherlands, the Philippines, and the Soviet Union believed the appropriate form should be a binding convention. They proposed that a convention would be the best embodiment of the rules because it would: (1) gain wide acceptance as it was negotiated by a large group of states; (2) provide the greatest certainty of unifying the common and civil law systems; (3) take precedence over national law—giving certainty to it—and if domestic law changes, the convention would not be affected. These countries saw a convention as the most desirable method despite its high cost of negotiation.

Some of the responding states who believed a convention was a bad idea set forth the following reasons: (1) that it would hardly be adhered to by many countries; (2) that the need for unification on this subject is not that great; (3) that developing nations do not see this as a priority for devoting their resources; and (4) the small number of articles in the draft is not appropriate for a worldwide convention. One country—Canada—believed that the convention should only apply to the transaction if both the contracting parties agreed to it in writing.

### 2. *Those in Favor of a Model Law*

A number of states felt that the best form of unification would be a model law. A model law is a suggested pattern for legislators in individual governments to consider adopting as part of their domestic legislation. The states in favor of this form were: Hungary, Japan, Poland, Republic of Korea, and Spain. These states believed this would be the best way to actually get the changes made in domestic legislation because it would allow individual governments to look to the model and make any necessary changes needed to conform to their own domestic policies. The critics of this view pounced on its flexibility as its most undesirable trait: Germany, Austria, and the Philippines believed that national governments would only adopt the rules sparingly and with significant alterations.<sup>99</sup> Different states would make different modifications and the whole premise—to create unification and certainty—would be rendered a pointless exercise.

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most to say about the model rules, and it was their legal systems that would lead to the most difficulties in adoption.

98. Unfortunately, the lack of documentary evidence is frustrating. It is not clear what some of the major players' views on this matter were. For instance, it is not clear what stance the United States or even France took.

99. *Draft Expert Analysis*, *supra* note 95, at 36; U.N. Doc. A/CN.9/219/Add.1 at 39.

### 3. *Those in Favor of UNCITRAL Rules (General Conditions)*

Some countries felt that the best alternative was to make the uniform rules in the form of General Conditions. General Conditions give parties guidance in drafting their contracts by giving illustrative examples of provisions to be used. The main upshot of this format is that the Rules would not apply unless the parties expressly agree to opt into them. The countries in favor for this method were Canada, The Federal Republic of Germany, Norway, Sweden, Turkey, and Venezuela. These nations contended that this form: (1) would give the parties great freedom in the way they form their contracts; (2) would offer uniform criteria that the parties would be able to adopt; and (3) could be used by parties immediately after the Commission finalizes them—rather than the lengthy treaty ratification process or the slow adoption of model laws by national legislatures. . Norway noted that the problems relating to modification (*Articles F and G*), which have been the most contentious provisions, could be left to each state's applicable law. Venezuela took a realistic—if not cynical—approach to the matter and stated “unification in this field is not a matter of priority, the formulation of general conditions is the most practical and realistic approach, despite limited unification achieved thereby.”<sup>100</sup>

The criticism of adopting this structure was that general conditions are invalid if they conflict with mandatory provisions of the applicable law regulating liquidated damages or penalty clauses.<sup>101</sup> Essentially, even if parties agree to insert a penalty clause, there is no guarantee a court or tribunal will enforce it if it contravenes the domestic law. Having such a provision would thus be wasteful—and using the international community's resources to establish these conditions would be doubly so. Additionally, Argentina argued that there was no guarantee that parties would ever actually incorporate these terms into their contracts.<sup>102</sup> The lack of widespread usage would largely defeat the purpose of worldwide harmonization.

### 4. *Substantive Provisions: Concerns and Comments*

After the responding parties set forth their preferences for the final embodiment of the Rules, and gave their analysis of why or why not the alternatives were viable, the responding states proceeded to discuss the substantive provisions in more detail. Sweden took issue with the drafting of *Article E*, because it noted that in some instances, if enforcing the sum and performance in the event of delay, it is not clear when extreme

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100. *Id.* at 36.

101. *Id.*

102. Though there is no empirical data that this author could find on whether parties actually incorporated model terms into their agreements, this might be an interesting point for further analysis. A good place to start would be to evaluate the frequency with which parties willingly adopt UNIDROIT principles into their contracts—this might give some indication as to the utility or futility of such a form.

delay has ripened into non-performance. Sweden suggested “it may be impossible to determine whether the breach is delay or non-performance until the delay has lasted so long that it is evident performance will never take place.”<sup>103</sup> Though it didn’t propose an alternative to the language, Sweden did highlight this as an issue that could be problematic.<sup>104</sup> The unavoidable end result of this problem then, is that the determination of whether delay has risen to the level of nonperformance would be left to the applicable domestic law.

One provision that caused a good deal of debate was once again *Draft Article G*.<sup>105</sup> Sweden was of the opinion that all factors should be considered by a court, both before the contract and after its conclusion in determining whether to adjust it downward. In essence, they propounded a holistic approach. Argentina countered however, that limiting judicial intervention preserves certainty and therefore *Article G* (2), which allows for judicial modification, should be construed restrictively. Argentina proposed that there should be a reduction only when “the disproportion between the loss suffered by the obligee and the agreed sum is such that by recovering the agreed sum the obligee will obtain an *obvious, unequivocal* and *clearly disproportionate* advantage without any justifying cause.”<sup>106</sup> Clearly, Argentina was of the opinion that certainty should win out over equity. It appears the country wanted to exercise as much judicial restraint as possible and give legal effect to these clauses unless they were outrageous. The ultimate language, despite Argentina’s suggestions, did not include this limiting language—it only required that “the agreed sum is substantially disproportionate in relation to the loss that has been suffered by the obligee.”<sup>107</sup>

The Federal Republic of Germany also noted that if the Rules take the form of General Conditions, then *Article G* will be moot because many countries already have built in protections for weaker parties such as un-

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103. Report of the Secretary-General: Analysis of expert opinions and of replies to the Secretariat questionnaire on liquidated damages and penalty clauses, *supra* note 33, at 38.

104. Sweden also was concerned with the language in Draft Article F, which allowed an upward adjustment if the obligee’s damages exceeded the agreed sum. They noted, as others had, that this removes certainty for the parties. They did acknowledge the provision’s utility, but requested a broadening of the things to be considered for the upward adjustment by a court, such as gross negligence of the obligor. The final draft didn’t contain this language despite Sweden’s request.

105. Draft Article G reads: “(1) The agreed sum shall not be reduced by a court or arbitral tribunal. (2) However, the agreed sum may be reduced if it is shown to be grossly disproportionate in relation to the loss that has been suffered by the obligee, and if the agreed sum cannot reasonably be regarded as a genuine pre-estimate by the parties of the loss likely to be suffered by the obligee.” The Rule, *supra* note 60, at 29.

106. Report of the Secretary-General: Analysis of expert opinions and of replies to the Secretariat questionnaire on liquidated damages and penalty clauses, *supra* note 33, at 38-39 (emphasis added).

107. Uniform Rules on Contract Clauses for an Agreed Sum Due upon Failure of Performance, [1983] 14 Y.B. Int’l Trade Comm’n 272, U.N. Doc. A/CN.9/243 [hereinafter “Uniform Rules”].

conscionability, lesión etc.<sup>108</sup> Germany believed that, in such cases, there should be some language stating that when the Rules conflict with mandatory provisions of domestic law, the latter shall prevail.<sup>109</sup> Lastly, the Netherlands made a comment here that appears to have gained wide support. They advocated that the adjustability of a court or tribunal is not a provision that should be waivable by the parties and that this rule should be explicitly stated. As discussed before, it would be patently unfair to allow an oppressive sum to be included, because of uneven bargaining power, only to have it then be uncontestable by the oppressed party because the stronger party was able to include another clause stating that the sum was not subject to modification.<sup>110</sup>

## V. THE FINAL DRAFT

After nearly four years of formulation, UNCITRAL finally created a document that was to be submitted to the Member Nations for them to determine whether to enact it as a model law or to ratify it as a convention. This final draft contained language to make it adaptable as either a convention or alternatively a model law. The uniform rules that the document contained reflected much of the language and commentary that the parties discussed in the various sessions, and which this paper has spoken of at length. Some suggestions seem to have been dismissed off-hand and others apparently received wide support as they were embodied in the final draft.

### A. TEXT OF THE UNIFORM RULES

The final draft of the uniform Rules is as follows:<sup>111</sup>

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108. See, e.g., U.C.C. § 2-302; BGB §138(2) (F.R.G.) ("A legal transaction by which a person exploiting the need, inexperience, lack of sound judgment or substantial lack of will power of another, causes to be promised or granted to himself or to a third party in exchange for a performance, pecuniary advantages which are in obvious disproportion to the performance is also void."); Mexican Civil Code art. 17 ("If by reason of extreme ignorance, inexperience or hardship of one party, another person obtains an excessive enrichment which is evidently disproportionate to the consideration given in return, the injured party shall have the right to elect a rescission of the contract or an adjustment in the consideration due from him, in addition to the damages suffered thereby."); Civil Code, Book Four §13(Chili); Civil Code art. 157(Braz.) ("An injury shall be held to occur whenever a person, under urgent need, or for inexperience, undertakes to a payment or performance that is manifestly disproportionate to the consideration given by the other party").
109. Report of the Secretary-General: Analysis of expert opinions and of replies to the Secretariat questionnaire on liquidated damages and penalty clauses, *supra* note 33, at 40. This of course would completely eliminate the certainty the Convention aimed to achieve. This argument did not appear to gain support as it was not in the final draft of the Rules.
110. See *supra* note 64. See also Report of the Secretary General: revised text of draft uniform rules on liquidated damages and penalty clauses, [1983] 14 Y.B. Int'l Trade Comm'n 31 n. 30, U.N. Doc. A/CN.9/235 (this was further codified in its later iteration).
111. Note that the accompanying standardized language enabling it to be entered into force as a convention has been omitted.

UNIFORM RULES FOR CONTRACT CLAUSES FOR AN AGREED SUM DUE  
UPON FAILURE OF PERFORMANCE

PART ONE: SCOPE OF APPLICATION

ARTICLE 1

These Rules apply to international contracts in which the parties have agreed that, upon failure of performance by one party (the obligor), the other party (the obligee) is entitled to an agreed sum from the obligor, whether as a penalty or as compensation.

ARTICLE 2

(Formerly Draft Article A)

For the purposes of these Rules:

(a) A contract shall be considered international if, at the time of the conclusion of the contract, the parties have their places of business in different States;

(b) The fact that the parties have their places of business in different States is to be disregarded whenever this fact does not appear either from the contract or from any dealings between, or from information disclosed by, the parties at any time before or at the conclusion of the contract;

(c) Neither the nationality of the parties nor the civil or commercial character of the parties or of the contract is to be taken into consideration in determining the application of these rules.

ARTICLE 3

(Formerly Draft Article B)

For the purposes of these Rules:

(a) If a party has more than one place of business, his place of business is that which has the closest relationship to the contract and its performance, having regard to the circumstances known to or contemplated by the parties at any time before or at the conclusion of the contract;

(b) If a party does not have a place of business, reference is to be made to his habitual residence.

ARTICLE 4

(Formerly Draft Article C)

These Rules do not apply to contracts concerning goods, other property or services which are to be supplied for the personal, family or household purposes of a party, unless the other party at any time before or at the conclusion of the contract, neither knew nor ought to have known that the contract was concluded for such purposes.



PART TWO: SUBSTANTIVE PROVISIONS

ARTICLE 5

(Formerly Draft Article D)

The obligee is not entitled to the agreed sum if the obligor is not liable for the failure of performance.

ARTICLE 6

(Formerly Draft Article E)

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

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

ARTICLE 7

(Formerly Draft Article F)

If the obligee is entitled to the agreed sum, he may not claim damages to the extent of the loss covered by the agreed sum. Nevertheless, he may claim damages to the extent of the loss not covered by the agreed sum if the loss substantially exceeds the agreed sum.

ARTICLE 8

(Formerly Draft Article G)

The agreed sum shall not be reduced by a court or arbitral tribunal unless the agreed sum is substantially disproportionate in relation to the loss that has been suffered by the obligee.

ARTICLE 9

The parties may derogate from or vary the effect of articles 5, 6 and 7 of these Rules.<sup>112</sup>

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Rather than discuss each of these articles in turn—with the exception of Article 8—the provisions will be allowed to speak for themselves. The development of these provisions has been thoroughly expounded upon through an analysis of their generation, so it seems further explication would be redundant. There is, however, one provision that warrants fur-

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112. Uniform Rules on Contract Clauses for an Agreed Sum Due upon Failure of Performance, *supra* note 107, annex 1.

ther inquiry. Article 8, which was formerly *Draft Article G*, should be scrutinized further. If the two versions are compared side-by-side, the requirement of a genuine pre-estimate of damages is conspicuously absent from the final version. The draft version did not deviate all too much from UCC §2-718 which would make the pre-agreed sum appear to be more of a liquidated damages clause than a penalty. The final version though, seems to embrace the legality of a clause that serves *solely* as a penalty and lacks any attempt at pre-estimating true damages. It may help to look at the versions side by side:

#### DRAFT ARTICLE G

1. The agreed sum shall not be reduced by a court or arbitral tribunal.
2. However, the agreed sum may be reduced if it is shown to be grossly disproportionate in relation to the loss that has been suffered by the obligee, and if the agreed sum cannot reasonably be regarded as a genuine pre-estimate by the parties of the loss likely to be suffered by the obligee.

#### ARTICLE 8 (final version)

The agreed sum shall not be reduced by a court or arbitral tribunal unless the agreed sum is substantially disproportionate in relation to the loss that has been suffered by the obligee.

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One can see that the language has changed in a slight (and probably trivial) way: “grossly disproportionate” has become “substantially disproportionate.” It is not clear if there is any meaningful difference between “grossly” and “substantially,” except possibly a minute difference in outrageousness of the amount. But one non-trivial change is the axing of the “genuine pre-estimate” by the parties portion. Now, as discussed above in the editorial commentary on *Draft Article G*, it appears that the drafters tried to move away from a version that might appeal to the common law countries and instead opted for a civil approach which would give more legal effect to the will of the parties by enforcing a penalty that never aimed to provide just compensation. No longer is the subjective intent of the parties relevant; the only safeguard remaining is the judicial ability to modify the egregiousness of an excess amount.

One can only surmise that the nixing of this key protection was a point of contention for the common law countries and *may* have led to the demise of UNCITRAL’s harmonization attempt. Unfortunately there is no official commentary that can be found which discusses the thought process in dropping the genuine pre-estimate language between the creation of *Draft Article G* and the final Article 8. There is also no real discussion to be found which names the parties or countries who may have taken objection to the draft language. One can only surmise that someone made an objection to the inclusion of the symbolic good faith require-

ment of a pre-estimate by highlighting its superfluity or its chilling effect on potentially beneficial coercive clauses.

Of the sparse commentary on the matter, there is only a brief discussion of the issue of the genuine pre-estimate. In June 1982, delegates from the Federal Republic of Germany and Norway objected to the requirement that *both* conditions be satisfied—the disproportionate sum *and* the genuine pre-estimate. They argued that the provisions should be joined by an *or* before the court could adjust the sum. This would effectively give judges the discretion to modify an award if the sum was unreasonably excessive *or* if the amount was meant to be a bona fide attempt at predetermining damages. Curiously, the final draft *completely* deleted any reference to a pre-estimate. It might have been the case that common law countries would have been more receptive to the draft recommended by Norway and Germany, which would permit judicial discretion if the amount was excessive or if the parties meant for it to reflect foreseeable damages. Without the genuine pre-estimate language, common law countries might have felt that having judges determine when a sum is substantially excessive as the *only* protection would not sufficiently protect weaker parties (or alternatively might discourage what they perceived to be the desirable notion of efficient breach).<sup>113</sup>

Other than the removal of the genuine pre-estimate language, there seems to be little in the final draft that would be cause for much discord. But as a point of general observation, the final draft's language does seem to have a cleaner appearance than the earlier drafts—the finished version lacks some of the qualifying language that the various drafters often wanted inserted. That being said, this version seems to reflect the general consensus that the writers and commentators came to during the many drafts and comments over the preceding four years.

#### B. RECOMMENDATION FOR ADOPTION

On December 19, 1983, the General Assembly of the United Nations, at its 101st plenary meeting, gave a brief introduction before its recommendation, extolling the virtues of the Uniform Rules. The Assembly then proceeded to "[r]ecommend[ ] that States should give consideration to the Uniform Rules on Contract Clauses for An Agreed Sum Due upon Failure of Performance adopted by the United Nations Commission on International Trade Law and, where appropriate, implement them in the form of either a model law or a convention."<sup>114</sup>

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113. As discussed previously, it is not clear which justification is more important to common law countries; public policy concerns or efficient breach. From the limited evidence, it seems the public policy concern against inequitable bargains has been the likelier driving force.

114. G.A. Rs. 38/135, at 270 (Dec. 19, 1983). The said recommendation was qualified by the General Assembly. It wrote:

*Recognizing* that 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,

Unfortunately, this is where the documentary record ends. Following this General Assembly resolution, there is virtually no information as to what the member states decided to do—or not do—with regards to the recommendation. What is clear, however, is that somehow the proposal died. No model law or convention was ever adopted or entered into. UNCITRAL halted work on the matter and little has changed approximately thirty years later. UNCITRAL will only resume work on this at Governments' requests, which for the time being do not appear to be forthcoming.

The question we are left with is *why*? Why were the Uniform Rules never adopted? Why did countless scholars and government representatives toil for years on these provisions—expending countless man-hours and unknown sums for negotiations and revisions—only to have the Rules remain as little but a footnote in legislative history? It may never be fully understood since the documentary record is so sparse following the adoption by UNCITRAL of the Model Rules themselves. Unless more first-hand documentation is obtained from the state representatives or the drafters themselves, the only evidence we are left with is circumstantial.

Despite the lack of a “smoking gun,” it does seem that the countless drafts do give some excellent insights as to the possible reasons this attempt at uniformity never took off. It seems the philosophical hurdles between the civil and common law systems were too significant to overcome. It seems that the provisions might not have been an issue pressing enough to rally enough support to effectuate anything binding for the many countries that had other priorities for their limited legislative resources. Though it was almost uniformly agreed that the disparate treatment of these clauses impeded international commerce, another reason might have been that the substance of the Uniform Rules were still too irksome to countries that were cynical about oppressive clauses on weak parties. Even with the allowance of judicial modification of the agreed

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*Noting* that the effect and validity of such clauses are often uncertain owing to disparities in the treatment of such clauses in various legal systems,

*Believing* that these uncertainties constitute an obstacle to the flow of international trade,

*Being of the opinion* that it would be desirable for the legal rules applicable to such clauses to be harmonized so as to reduce or eliminate the uncertainties concerning such clauses and remove these uncertainties as a barrier to the flow of international trade,

*Noting* that the United Nations Commission on International Trade Law has adopted Uniform Rules on Contract Clauses for An Agreed Sum Due upon Failure of Performance,

*Recognizing* that there are various ways in which the Uniform Rules on Contract Clauses for An Agreed Sum Due upon Failure of Performance could be implemented by States, and being of the opinion that a recommendation by the General Assembly to states that they should implement the Uniform Rules in an appropriate manner would not prejudice the Assembly from making a further recommendation or taking further action with respect to the Uniform Rules if circumstances so warrant.

sums and the exclusion of non-sophisticated parties, the concessions might still not have been enough to overcome the sense that injustice would befall these weaker bargainers.

For common law countries, it might have been too uncomfortable a pill to swallow for courts to apply two standards of justice—if the transaction was solely domestic, then the judicial safety net could be fully applied, but if it touched across borders, then the parties would be afforded fewer protections. One gets the sense that a reluctance to apply these two tiers of justice may have been what stalled the agreement. But it may have even been the case that the effort died for lack of interest. Unless more documentation comes to light, these questions will remain largely unanswered. Though, hopefully through the analysis of the generation of the unification attempt, one can gain a better understanding of the divisive issues, and a better appreciation of those that were readily acceded.

## VI. CONCLUSION

This paper aimed to elucidate some of the possible reasons the international community has thus far failed to adopt a uniform approach to liquidated damages and penalty clauses. It also attempted to give a brief introduction into these clauses by explaining their history, their treatment under different legal systems, and by giving a taste of the philosophical debate that surrounds their utility. Regrettably, the objective to give concrete reasons for UNCITRAL's failure at unifying the international law was not achieved due to a lack of solid evidence, but through the distillation of the many drafts and years of debate surrounding the issue, the key ideas have been brought into focus.

It is important that this subject not fade away; these types of clauses are still used today, and are probably more important now than they were in 1979 as cross border trade has grown exponentially. New issues have arisen which raise a whole slew of problems related to this matter—the rise of new types of economic actors, the increased prevalence of outsourcing of services to foreign countries, the ubiquity of electronic contracts with form clauses, etc. All these issues, and many others, significantly intersect the unresolved problem of pre-arranged sums. To this day, unless the parties provide for the applicable law—and are aware what the corresponding conflicts of law treatment will be—there will remain uncertainty in international commerce regarding prearranged sums payable on breach. It is imperative then, that at some point in the near future this work is taken up again and the drafters find some way to make sufficient concessions so that there can be widespread application.

There has been a steady trend over the decades for the common law and the civil law to come together towards a consensus on many topics; one can only hope that on this key issue, there will also be some point where the systems can come to an agreement. Additionally, in the many years following this attempt, academics have developed a good amount of scholarship about the virtues and pitfalls of these clauses and much has

been written to question the common law's steadfast adherence to its paternalistic treatment of penalty clauses.<sup>115</sup> One can only hope that the gradual merger of the legal systems, coupled with the urgings of academic literature, might one day cause the common law to entertain these types of agreements. Until that day, uncertainty remains.

ANNEX 1  
COUNCIL OF EUROPE  
PENAL CLAUSES IN CIVIL LAW

Resolution (78)3 Adopted by the Committee of Ministers  
of the Council of Europe on 20 January 1978

The Committee of Ministers

Considering that the aim of the Council of Europe is to achieve greater unity between its members, in particular by the adoption of common rules in the field of law;

Considering that it is necessary to provide for judicial control over penal clauses in civil law in appropriate cases where the penalty is manifestly excessive;

Considering that penal clauses applicable on breach of contract constitute the most typical and frequent form of penal clauses and that it is therefore desirable to provide common rules for such clauses,

Recommends governments of member states:

1. to take the principles concerning penal clauses in civil law contained in the appendix to this resolution into consideration when preparing new legislation on this subject;
2. to consider the extent to which the principles set out in the appendix can be applied, subject to any necessary modifications, to other clauses which have the same aim or effect as penal clauses;
3. to make this resolution and its appendix and the explanatory memorandum 1 available to the appropriate authorities and other interested bodies in their countries.

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115. See Charles J. Goetz & Robert Scott, *Liquidated Damages, Penalties and the Just Compensation Principle: Some notes on an Enforcement Model and a Theory of Efficient Breach*, 77 COLUM. L. REV. 554 (1977) (though this article predates the UNCITRAL draft, it is an important piece on the desirability of enforcing penalty clauses); Aristides N. Hatzis, *Having the cake and eating it too: Efficient Penalty Clauses in Common and Civil Contract Law*, 22 INT'L REV. L. & ECON. 381, 384 (2002); Larry DiMatteo, *A Theory of Efficient Penalty: Eliminating the Law of Liquidated Damages*, 38 AM. BUS. L.J. 633, 641 (2001); Ugo Mattei, *The Comparative Law and Economics of Penalty Clauses in Contracts*, 43 AM. J. COMP. L. 427 (1995).

## APPENDIX

## ARTICLE 1.

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

## ARTICLE 2.

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

## ARTICLE 3.

A penal clause shall not of itself prevent the promisee from obtaining specific performance of the principal obligation instead of the sum due under that clause.

## ARTICLE 4.

The sum stipulated shall not be due unless the promisor is liable for the failure to perform the principal obligation.

## ARTICLE 5.

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

## ARTICLE 6.

Despite any stipulation to the contrary, the promisee cannot obtain a sum in excess of either the sum stipulated under the penal clause or the damages payable for the failure to perform the principal obligation whichever is the larger.

## ARTICLE 7.

The sum stipulated may be reduced by the court when it is manifestly excessive. In particular, reduction may be made when the principal obligation has been performed in part. The sum may not be reduced below the damages payable for failure to perform the obligation. Any stipulation contrary to the provisions of this article shall be void.

## ARTICLE 8.

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

## ANNEX 2

BENELUX CONVENTION  
Uniform Law Relating to Penal Sums  
Concluded at the Hague No. 18360  
26 November, 1973

## ARTICLE 1.

1. The judge may, at the request of one party, sentence the other party to pay a sum of money, called a penal sum, in the event of failure to comply with the principal judgment, without prejudice to the right to damages if grounds therefore exist. A penal sum may not, however, be imposed where a party has been sentenced to pay a sum of money.
2. The request may be considered even if it is submitted for the first time in a third-party action or on appeal.
3. The penal sum may not fall due before notification of the judgment by which it is established.
4. The judge may grant the sentenced party a period of time during which the penal sum may fall due.

## ARTICLE 2.

1. The judge may specify the penal sum as a lump sum, as a fixed sum per unit of time or as a fixed sum per contravention. In the latter two cases the judge may also specify an amount above which no further penal sum may fall due.

## ARTICLE 3.

1. The penal sum, once due, shall become fully the property of the party that requested the sentence. The said party may take legal action for its recovery by virtue of the title which establishes the penal sum

## ARTICLE 4.

1. The judge who has imposed a penal sum may, at the request of the sentenced party, revoke the sentence, suspend it for a period of time fixed by him or reduce the penal sum in the event of permanent or temporary inability of the sentenced party to comply with the principle sentence.
2. To the extent that the penal sum had fallen due before the inability occurred, the judge may not revoke the sentence or reduce the penal sum.

## ARTICLE 5.

1. The penal sum may not fall due while the sentenced party is in bankruptcy.
2. Penal sums due before the declaration of bankruptcy shall not be counted as liabilities of the bankruptcy.



ARTICLE 6.

1. Upon the death of the sentenced party, the penal sum set at a fixed sum per unit of time shall no longer fall due, but the penal sums which fell due before the death shall continue to be payable. The penal sum shall become once again payable by the heirs or beneficiaries of the sentenced party only after the judge who imposed the penal sum so decides. He may change the amount and the conditions.
2. Other penal sums may, at the request of the heirs and other beneficiaries, be cancelled or reduced by the judge who imposed them, either temporarily or permanently and, if necessary, with effect from the date on which the sentenced party died.

ARTICLE 7.

1. The penal sum shall become void by prescription upon the expiry of six months from the date of which it fell due.
2. Prescription shall be suspended in the event of bankruptcy or any other legal impediment to the collection of the penal sum.
3. Prescription shall also be suspended during such time as the party that requested the sentence cannot reasonably be expected to be aware that the penal sum has fallen due.

ARTICLE 8.

1. The penal sum shall not be taken into account in determining judicial competence and the possibility of appeal.<sup>116</sup>

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116. Benelux Convention, The Hague, Neth., Nov. 26, 1973, Vol. 1162,1-18360, *available at* [http://untreaty.un.org/unts/60001\\_120000/3/2/00004081.pdf](http://untreaty.un.org/unts/60001_120000/3/2/00004081.pdf).