Title: Enforcement of Penalty Clauses in Civil and Common Law: A Puzzle to be Solved by the Contracting Parties
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Abstract:

This paper claims that there is a need for transnational rules to secure the enforcement of penalty clauses in international commercial contracts, due to the insufficiency of the contractual toolkit that parties may use to address both the clash between the civil and the common law traditions, and existing disparities among civil laws in this area. The international community acknowledged this need a long time ago, but unfortunately the tremendous effort exerted in many different harmonization projects is unlikely to lead to the certainty that actors in international trade demand.
ENFORCEMENT OF PENALTY CLAUSES IN CIVIL AND COMMON LAW: A PUZZLE TO BE SOLVED BY THE CONTRACTING PARTIES

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1. INTRODUCTION

In the field of penalty clauses, defined as any agreement for the payment of a fixed sum on breach of contract, one of the most distinctive features among civil and common law systems is the extent of the judicial review of the stipulated sum. While common law courts may declare unenforceable such agreement by virtue of the principle of just compensation,¹ civil law courts may only reduce a grossly excessive stipulated sum. The agreed sums exceeding the actual loss of the promisee are unlikely to be enforced by Anglo-American judges,² and those deemed extremely high by Continental European judges are also moderated. Therefore, broadly speaking, the principle of non-enforcement of contract penalties governs in common law, and the principle of enforcement of penalties subject to reduction controls in civil law.

The main difference between these two legal traditions lies on their different notions about contract liability: in common law systems, the payment of damages constitutes true fulfillment of the contractual promise. Whereas, in civil law systems, contract liability is an effect arising from the breach or a sanction.³ Thus, for a civil lawyer, the amount stipulated is always intended to be higher than the loss.⁴

In a comparative view, the major objection against the common law of penalties is that parties are placed in the worst of all possible scenarios, without the flexibility of enforcement of penalties subject to reduction (most civil law systems), and without the certainty of literal enforcement of penalties (Spain).⁵ Indeed, from the economic analysis of law, the extreme rigidity of common law courts has been criticized on account of judges disregarding upon these provisions with disfavor,⁶ since any judicial review resulting in the unenforcement of penalties threatens the function of

¹ In these jurisdictions, contract law does not aim to force the promisor to perform, but to compensate adequately the aggrieved promisee, E. Allan Farnsworth, Contracts (4th edn, Aspen 2004) 811. Regarding the principle of just compensation, the holdings of two cases, one American and the other English, are very illustrative of the fact that in common law systems freedom of contract encompasses such a wide autonomy for the parties to enter a contract, but a much more restrictive one to arrange remedies against its breach. First, in Jaquith v Hudson 5 Mich 123 (Mich 1858), the Supreme Court of Michigan stated that ‘courts will not permit the parties by express stipulation, or any form of language, however clear the intent, to set it aside’. Second, in Addis v Gramophone Co. [1909] AC 488 (HL), the House of Lords insisted that ‘damages for breach of contract [are] in the nature of compensation, not punishment’.

² Nevertheless, English law and American state laws present substantially different regimes governing liquidation of damages, with respect to the analysis of its validity and the legal consequences for a penalty clause.

³ Judge Holmes noted that ‘the duty to keep a contract at common law means a prediction that you must pay damages if you do not keep it, - nothing else’ (Oliver W Holmes, Jr, ‘The Path of the Law’ (1897) 10 Harv L Rev 457, 477). See also Fernando Pantaleón Prieto, ‘Las nuevas bases de la responsabilidad contractual’ (1992) 46 Anuario de Derecho Civil 1719, 1737-40.


this remedy against breach. However, in international commercial contracts, the enforcement of those penalties constitutes an even major concern, since uncertainty is much higher due to the applicable law and the court decision when adjudicating the dispute or executing the judgment or the arbitration award.

Part I briefly presents the rules governing penalties in three different jurisdictions: a common law jurisdiction, the United States (Section I.1), and two civil law jurisdictions with fundamental distinctions, France and Spain (Section I.2); and the case law is explored to show how cases with the same facts lead to different outcomes depending on the applicable legal regime (Section I.3). Next, Part II denounces the lack of transnational rules to secure the enforcement of penalties in international commercial contracts (Section II.1). Furthermore, Part II explains why the will of the contracting parties may be at risk in an international litigation or arbitration in the absence of coordination instruments among the several jurisdictions (Section II.2). Finally, instead of transnational rules, the statutory recognition at national level of penalties in international commercial contracts is proposed in Part II as the most feasible solution to shield the enforcement of penalties in common law jurisdictions (Section II.3).

2. THE CIVIL-COMMON LAW COMPARISON OF RULES GOVERNING PENALTIES

2.1. United States: the Principle of Non-Enforcement of Penalties

American state laws stick to the common law rule of non-enforcement of penalties. Liquidation of damages is a permissible method of limiting the defaulting promisor’s liability for compensatory damages: the parties agree at the time of contracting that damages for breach will be limited to a prescribed formula. Nonetheless, if the stipulated amount entails an undue oppression on the promisor, liquidated damages may be held to be a penalty and, therefore, unenforceable. This rule has been characterized as anomalous, particularly because contracting parties lack power to bargain over their remedial rights in a legal system in which freedom of contract is a deeply rooted principle.8


The most illustrative case on the American common law of penalties is Banta v. Stamford Motor Co. (1914),\(^9\) opinion which firstly delineated the test to determine whether a provision for the payment of a stipulated sum in the event of a breach of contract will be regarded as one for liquidated damages. This test was formed by three conditions:

These conditions . . . are (1) the damages to be anticipated as resulting from the breach must be uncertain in amount or difficult to prove; (2) there must have been an intent on the part of the parties to liquidate them in advance; and (3) the amount stipulated must be a reasonable one, that is to say, not greatly disproportionate to the presumable loss or injury.\(^10\)

The subsequent case law further elaborated this test in such a way that the second condition, the intent of the parties, did not survive over time;\(^11\) and the third condition has been relaxed in the sense that the reasonableness of the amount stipulated may also be ascertained in the light of both the anticipated or actual loss, instead of only the anticipated loss at the time of contracting (in Banta, the so-called 'presumable loss').\(^12\)

In addition, the difficulty of proof of loss at the moment of contracting still continues as the other relevant factor for the assessment of the reasonability of the amount stipulated,\(^13\) although the ease of proof alone should not be purported to deem the agreed sum as a penalty.\(^14\)

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\(^9\) Banta v Stamford Motor Co. 92 A 665 (Conn 1914), the Supreme Courts of Errors of Connecticut upheld as a valid liquidation of damages the agreed sum of $15 a day for delay in the delivery of a luxury yacht priced at $5,500.

\(^10\) Ibid 667-68.

\(^11\) Restatement (Second) of Contracts § 356 cmt c (1981): 'Neither the parties' actual intention as to its validity nor their characterization of the term as one for liquidated damages or a penalty is significant in determining whether the term is valid'. See also Wassenaar v Panos 331 N.W.2d 357 (Wis 1983), ruling the Supreme Court of Wisconsin that the 'subjective intent of the parties has little bearing on whether the clause is objectively reasonable'; Farnsworth (n 1) 817, explaining that the inquiry goes to whether the effect of upholding the stipulation improperly compels performance; Joseph M Perillo, Corbin on Contracts (11th edn, vol 11, Lexis Nexis 2005) 427, stating that, even in those jurisdictions which formally keep intention as an independent factor, intention is derived from an objective test, so this prong of the test is redundant.

\(^12\) This clash between the classical requirement that the sum must be a genuine pre-estimate of the harm (reasonableness ex ante) and the alternative that the sum must be reasonable at the time of breach when compared with the actual harm (reasonableness ex post) remains unsolved. In this vein, the Restatements have never opted for one of them, and the Uniform Commercial Code either. Restatement (First) of Contracts § 339(1) (1932), without referring to any of the two criteria; Restatement (Second) of Contracts § 356 cmt b (1981), explicitly admitting both criteria, albeit acknowledging that each one leads to different results; UCC § 2-718(1) (1977).

\(^13\) Restatement (Second) of Contracts § 356 cmt b (1981): 'If the difficulty of proof of loss is great, considerable latitude is allowed in the approximation of anticipated or actual harm. If, on the other hand, the difficulty of proof of loss is slight, less latitude is allowed in that approximation'.

\(^14\) Dan B Dobbs, Law of Remedies, vol 3 (2nd edn, West 1993) 251, claiming that this is the right interpretation of Restatement (Second) of Contracts § 356(1) (1981); William D Hawkland, Uniform Commercial Code Series § 2-718:03, vol 2 (Clark Boardman Callaghan 1994), with respect to the UCC § 2-718(1) (1977), advocating that, in contrast with other common law jurisdictions, the difficulty of proof of loss at the moment of contracting has never been a requirement for the validity of the agreed damages clause in American contract law.
Hence, American courts apply today one single test of reasonableness with two elements, namely the disproportion of the agreed sum and the difficulty of proof of loss, in order to determine whether a liquidation of damages is a penalty.15

2.2. Civil Law: the Principle of Enforcement of Penalties Subject to Reduction (France) and the Principle of Literal Enforcement of Penalties (Spain)

The literal enforcement of conventional penalties was a rule of classical Roman law that entitled the aggrieved party to recover the agreed sum without any restriction16. In the XIXth century, the codification brought back the principle of literal enforcement of penalty clauses to Continental European laws.17 In this vein, the French Civil Code, as enacted in 1804, established the literal enforcement of conventional penalties in Article 1152: ‘[T]orsque la convention porte que celui qui manquera de l’exécuter paiera une certaine somme à titre de dommages-intérêts, il ne peut être alloué à l’autre partie une somme plus forte ni moindre’.18 The Napoleonic Code was the model for the neighboring nations (Belgium, Italy, Portugal and Spain) and their laws copied this regulation. Nonetheless, the liberal Roman principle of literal enforcement of penalties was progressively abandoned,19 and most European

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15 In comparison with the above mentioned sections of both Restatements, the UCC § 2–718(1) (1977) added a new parameter, ‘the inconvenience or nonfeasibility of otherwise obtaining an adequate remedy’. Although incorporated into state laws, courts rarely apply this additional factor. In fact, the American Law Institute has declared that the factors enumerated by the UCC do not operate as independent requirements for the validity of the clause, Motion Concerning Section 2–718(1) (May 11, 2001). See also Hawkland (n 14) § 2–718(04, arguing that the inclusion of this third factor is reiterative, since the difficulty of proof of loss already points to the availability of other adequate remedies; Ian R Macneil, ‘Power of Contract and Agreed Remedies’ (1962) 47 Cornell L Q 495, 528, asserting that historically court decisions had conferred great importance to this third additional factor when examining the validity of agreed remedies clauses.

16 Paulus (D. 44, 7, 44, 6).

17 The Justianian Code (C. 7, 47) limited the amount of damages claimable to the double of the value of what had been promised. Ius commune was also influenced by Canon law, which considered an unjustified gain those amounts that punished with severity the party in breach. Aristides N. Hatzis, ‘Having the Cake and Eating It Too. Efficient Penalty Clauses in Common Law and Civil Contract Law’ (2003) 22 Int’l Rev L & Econ 381, 399. See also Reinhard Zimmermann, The Law of Obligations: Roman Foundations of the Civilian Tradition (OUP 1996) 95–113.

18 ‘Where an agreement provides that the party who fails to perform it will pay a certain sum as damages, the other party may not be awarded a greater or lesser sum’, French Civil Code http://www.legifrance.gouv.fr> accessed 10 March 2012.

19 The Italian Civil Code enacted in 1942 (Article 1384); the Portuguese Civil Code enacted in 1966 (Article 812); and in Belgium, without any statutory reform, after the Belgian Cour de cassation Judgment, 24 November 24, the case law considers that extravagant contract penalties are against the public order and, for this reason, void. In 1975, the French Civil Code was reformed too. Law No 75–597 of 9 July 1975, JO 10 July 1975 7076, added a second paragraph to Article 1152: ‘Néanmoins, le juge peut modérer ou augmenter la peine qui avait été convenue, si elle est manifestement excessive ou dérisoire. Toute stipulation contraire sera réputée non écrite’ (‘Nevertheless, the judge may moderate or increase the agreed penalty, where it is obviously excessive or ridiculously low. Any stipulation to the contrary shall be deemed unwritten’, French Civil Code <http://www.legifrance.gouv.fr> accessed 10 March 2012). This article let the judge to increase or decrease a penalty found to be disproportionate. Moreover, Law No 75–597 reformed Article 1231, governing the reduction of the penalty in case of partial performance, stating that Article 1152 was also applicable: ‘Lorsque l’engagement a été exécuté en partie, la peine convenue peut être diminuée par le juge à proportion de l’intérêt que l’exécution partielle a procuré au créancier, sans préjudice de l’application de l’article 1152. Toute stipulation contraire sera réputée non écrite’ (‘Where an undertaking has been performed in part, the agreed penalty may be lessened by the judge in proportion to the interest which the part performance has procured for the creditor, without prejudice to the application of Article 1152. Any stipulation to the contrary shall be deemed not written’, French Civil Code <http://www.legifrance.gouv.fr> accessed 10 March 2012). Therefore, the same
legislations converged on allowing the judge to moderate those contract penalties which are grossly excessive. Thus, the judicial review of penalty clauses on the grounds of equity is the solution widely accepted by Continental European laws, since Germanic legal systems do also opt for it (Austria, Germany and Switzerland).20

In contrast with the majority of European civil law systems, Spanish law solely allows courts to reduce the penalty whether the breach of contract has less entity that the one anticipated by the contracting parties in the provision,21 so the judicial review on the grounds of equity is excluded.22 The Spanish Civil Code (Article 1154) imposes on the judge the duty to moderate the penalty if, and only if, the undertaking has been partially or irregularly performed.23 To moderate the penalty, the judge must assess the proportion between the actual performance and the performance that would have barred the claim of the penalty.24

Albeit the above mentioned differences concerning the grounds of the judicial review, European civil law systems share the same concept of penalty clause: a penalty might be reviewed by a French judge on the grounds of partial performance and on the grounds of equity.

20 German Civil Code (BGB § 343), although the German Commercial Code (HGB § 348) excludes contracts between professionals in the scope of their activity. Both Austrian law (§ 1336.2 Austrian Civil Code, ABGB) and Swiss law (Article 163-3 Code des obligations) admit the judicial review of disproportionate penalties too, but without a different regime for commercial contracts.

21 Fernando Gómez Pomar, ‘El Incumplimiento Contractual en Derecho Español’ (2007) 3 InDret <http://www.indret.com/pdf/466_es.pdf> accessed 10 March 2012. However, in lieu of the Spanish Civil Code, Navarrese civil law may apply, which is the only particular civil law of the Autonomous Communities with its own rules in the field of contract penalties. Actually, under Navarrese civil law, the coercive function of the penalty is especially protected, since the New Navarrese Code of Laws (Article 518) expressly provides that ‘the agreed penalty should not be reduced by judicial discretion’, so the penalty would not be adjusted on any ground, Navarra Superior Court Judgments, 27 January 2004 (RI, No 2668), and 9 November 2005 (RI, No 2006\377). See also José Ignacio Bonet Sánchez, ‘La cláusula penal’ in Ubaldo Nieto Carol and José Ignacio Bonet Sánchez (eds), Tratado de Garantías en la Contratación Mercantil, vol 1 (Civitas 1996) 887, 964-65. Recall that the Superior Courts of those Autonomous Communities with particular civil law have jurisdiction to adjudicate cases in which arise an issue related to the corresponding particular civil law.

22 The Spanish Supreme Court has constantly rejected the judicial review of penalty clauses on the grounds of equity, STS, 15 October 2008 (RI, No 5692). However, among other relevant changes, a tentative draft bill aims to explicitly introduce the judicial review on the grounds of equity, Comisión General de Codificación, Propuesta de Anteproyecto de Ley de Modernización del Derecho de Obligaciones y Contratos (2009), Article 1150. Within Spanish legal scholars, the majority position has always defended the need of a law reform that allows the judicial review of penalty clauses on the grounds of equity, María Dolores Mas Badía, La Revisión Judicial de las Cláusulas Penales (Tirant Lo Blanch 1995) 216; Isabel Espín Alba, Cláusula Penal. Especial Referencia a laModeración de la Pena (Marcial Pons 1997) 86. A minority position advocated that the current Article 1154 of the Spanish Civil Code (n 23) embraces judicial review on the grounds of equity, since the single requirement for the reduction is the disproportion between the penalty and the actual harm, Francisco Jordano Fraga, La Resolución por Incumplimiento en la Compraventa Inmobiliaria. Estudio Jurisprudencial del Artículo 1504 del Código Civil (Civitas 1992) 199-200; José Miguel Rodríguez Tapia, ‘Sobre la Cláusula Penal en el Código Civil’ (1993), 46 Anuario de Derecho Civil 511, 578-80.

23 Article 1154: ‘El Juez modificará equitativamente la pena cuando la obligación principal hubiera sido en parte o irregularmente cumplida por el deudor’ (“The Judge shall equitably modify the penalty where the principal obligation should have been performed partially or irregularly by the debtor”, Spanish Civil Code <http://www.mjusticia.es/cs/Satellite/es/1215198252168/DetalleInformacion.html> accessed 10 March 2012.

24 Article 1154: ‘El Juez modificará equitativamente la pena cuando la obligación principal hubiera sido en parte o irregularmente cumplida por el deudor’ (“The Judge shall equitably modify the penalty where the principal obligation should have been performed partially or irregularly by the debtor”, Spanish Civil Code <http://www.mjusticia.es/cs/Satellite/es/1215198252168/DetalleInformacion.html> accessed 10 March 2012.

25 Manuel Albaladejo García, Comentarios al Código Civil y a las Compilaciones Forales, vol 15(2) (Edersa 1983) 486. In consequence, there would be no moderation if the penalty was agreed upon the partial performance actually occurred, STS, 14 September 2007 (RI, No 5307).
provision seeking to deter breach by requiring the payment of extra-compensatory damages.

Beyond the grounds of the judicial review, which serve to classify a civil law system as one of enforcement of penalties subject to reduction or one of literal enforcement of penalties, there exist other minor but significant differences among the several penalty clause regimes pertaining to the civil law tradition. Next, the French and the Spanish law of penalties are compared in order to point out the most basic traits of each of them.

a) Even though the judicial review under Spanish law is much more restricted, the judicial intervention of the penalty is still exceptional in French law, because the disproportion must be an abuse of the coercive function, being obviously excessive, and having no justification.

b) While in Spanish law the judicial intervention of the penalty may consist only in the reduction of the sum stipulated, in French law the judge may reduce the penalty if manifestly excessive, or increase it if ridiculously low.

c) If applicable, Spanish courts must reduce the penalty, although the question about the possibility of an ex officio judicial intervention is more debatable. On the contrary, the French Civil Code (Articles 1152 and 1231) authorizes courts to exercise their judicial discretion when reviewing the ‘clause pénale’, once it has been determined that the sum stipulated is manifestly excessive or pitiful and also in the event of partial performance. Furthermore, in French law, the adjustment of the sum stipulated on the judge’s own motion is statutorily granted, which reinforces the discretionary judicial review of penalties.

In addition, in both legal systems, the question whether to adjust the sum stipulated and in which degree are reviewable by the appellate court but not by the highest court of ordinary jurisdiction, since each of these issues is

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considered a matter of fact instead of a matter of law. Therefore, the Spanish Supreme Court may decide these issues only on the basis of the prior finding that the lower court erred in qualifying promisor’s performance.\textsuperscript{31} In this regard, the French \textit{Cour de cassation} balances the stronger discretionary judicial review of penalties with a demanding requirement of accountability, reversing those judgments which alter the sum stipulated without articulating the factual reasons why the amount set fits into the above mentioned category of ‘manifestly excessive’\textsuperscript{32}

d) The French and the Spanish law of penalties have in common the application of an objective, retrospective test: despite not being entirely consistent,\textsuperscript{33} French courts compare the sum stipulated with the actual damages,\textsuperscript{34} and Spanish courts the breach anticipated in the provision with the actual breach.\textsuperscript{35} Whereas, the American common law of penalties and the Uniform Commercial Code provide not only the use of the applicable test retrospectively (reasonableness ex post), but also prospectively (reasonableness ex ante).\textsuperscript{36} Notwithstanding, in French law, the breaching party’s bad faith in the performance is a relevant factor in the determination of whether a penalty is ‘manifestly excessive’,\textsuperscript{37} unlike Spanish law, since this argument does not have any relevance.\textsuperscript{38}

e) Lastly, another significant difference between the French and the Spanish law of penalties is that the former bans the cumulative penalty, i.e. the aggrieved party is not jointly entitled to the payment of penalty and the performance of the obligation,\textsuperscript{39} while the latter allows the cumulative penalty, as long as this right has been clearly granted.\textsuperscript{40} French law makes a

\textsuperscript{31} STS, 20 December 2006 (RI, No 2007/388), and STS, 20 September 2006 (RI, No 8401).
\textsuperscript{33} Calleros (n 29) 105.
\textsuperscript{34} Denis Mazeaud, La Notion de Clause Pénale (LGDJ 1998) 57-58.
\textsuperscript{35} Gómez Pomar (n 21).
\textsuperscript{36} Restatement (First) of Contracts § 339(1) (1932); Restatement (Second) of Contracts § 356 cmt b (1981); UCC § 2-718(1) (1977) (n 12).
\textsuperscript{37} Calleros (n 29) 106, specifying that the Cour de cassation rejects the behavior of the parties as the sole basis to find a penalty manifestly excessive, Cass com, 11 February 1997, Bull civ II, No 47.
\textsuperscript{38} However, some scholars have defended the use of the argument of the bad faith to expand the grounds on which the reduction of the penalty is permitted, Jaime Santos Briz, ‘Comentario a los arts. 1152 a 1155 CC’ in Ignacio Sierra Gil de la Cuesta (ed), Comentario al Código Civil, vol 6 (Bosch 2000) 289, 296-97. Against, María Corona Quesada González, ‘Estudio de la Jurisprudencia del Tribunal Supremo sobre la Pena Convencional’ (2003) 14 Aranzadi Civil 45, arguing that the claim of the sum stipulated may not be deemed against the good faith, since contract penalties are allowed in Spanish law.
\textsuperscript{39} Article 1229 of the French Civil Code: ‘Il [le créancier] ne peut demander en même temps le principal et la peine, à moins qu'elle n'ait été stipulée pour le simple retard’ (‘He [the creditor] may not claim at the same time the principal and the penalty, unless it was stipulated for a mere delay’, French Civil Code <http://www.legifrance.gouv.fr> accessed 10 March 2012).
\textsuperscript{40} Article 1153 of the Spanish Civil Code: ‘Tampoco el acreedor podrá exigir conjuntamente el cumplimiento de la obligación y la satisfacción de la pena, sin que esta facultad le haya sido claramente otorgada’ (‘Neither may the creditor request jointly the performance of the obligation and the payment of the penalty, unless this power has been clearly granted’, Spanish Civil Code
single exception: the penalty for breach due to delay, which does not properly constitute a cumulative penalty, because the creditor will never obtain a timely performance of the already lately performed obligation. In the context of European civil law systems, the cumulative penalty is not a singularity of Spanish law.41

On a comparative account limited to Western Europe, French law cannot be generalized, and deemed as the European civil law model of contract penalties, due to the judicial power of increasing an unreasonably small agreed sum, since usually the penalty may only be reduced. Nevertheless, French law features the other characteristics of the wide majority of European civil laws: (1) the validity of contract penalties, which may have the effect of coercing a party to perform her obligation; (2) the judicial review of penalties on the grounds of equity as a discretionary faculty, based on a retrospective test considering the actual harm, or on the grounds of partial performance; and (3) the promisee’s entitlement either to the penalty or to specific performance, with the exception of delay, being deprived of claiming statutory damages.

41 German Civil Code (BGB § 341(1)), allowing the claim of performance in addition to the payable penalty when the penalty was promised for improper performance. On the contrary, following the French solution, the Italian Civil Code (Article 1383), the Portuguese Civil Code (Article 811), and the Austrian Civil Code (§ 1336.1 ABGB), including this latter the non-compliance with the promised place of performance too. In accordance with French law, the mandatory prohibition of the cumulative penalty is the solution recommended by the Council of Europe, Committee of Ministers Resolution (78) 3 Relating to Penal Clauses in Civil Law (1978) [hereinafter Council of Europe Resolution (78) 3], 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’. In fact, the cumulative penalty is not permitted in the tentative draft bill for the reform of the Spanish Civil Code (n 22) Article 1149; Isabel Arana de la Fuente, ‘Algunas Precisiones sobre la Reforma de la Cláusula Penal en la Propuesta de Modernización del Código Civil en Materia de Obligaciones y Contratos’ (2010) 4 InDret 8-9 <http://www.indret.com/pdf/775_es.pdf> accessed 10 March 2012. Notwithstanding, shortly before the Council of Europe Resolution (78) 3, the Common Provisions Annexed to the Benelux Convention on Penalty Clauses (1973) Article 2(1)-(2), contained the exclusion of the cumulative penalty but as a default rule instead of mandatory, being excludable by the parties’ agreement, Thilmamy (n 27) 41. The exclusion of the cumulative penalty unless otherwise stipulated by the parties was also the solution adopted by the UN Commission on International Trade Law [UNCITAL] in the Text of Draft Uniform Rules on Liquidated Damages and Penalty Clauses, together with a Commentary thereon (1981) UN Doc A/CN.9/218 [hereinafter UNCITAL Draft] Article E: ‘(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’. Despite acknowledging that the cumulation of the two remedies might unjustly enrich the obligee in some circumstances, the Revised Text of Draft Uniform Rules on Liquidated Damages and Penalty Clauses (1983) UN Doc A/CN.9/235 [hereinafter UNCITAL Revised Draft], this revised draft of uniform rules does not follow the recommendation of the Council of Europe: Article E(3) was deleted, but Article E(2) was amended by including an exception under which the obligee is entitled to performance and the agreed sum when proving that the later cannot reasonably substitute the former, and Article X was added, providing that ‘[t]he parties may by agreement only derogate from or vary the effect of articles D, E and F of this [Convention]law’. See also the final endorsement of this solution, contrary to the recommendation of the Council of Europe, Uniform Rules on Contract Clauses for an Agreed Sum Due upon Failure of Performance (1983) UN Doc A/CN.9/243 [hereinafter UNCITAL Uniform Rules] Annex I, Articles 6(2) and 9.
Regarding this third common characteristic, German law is neither representative: not only the cumulative penalty is permitted, but also the promisee is entitled to claim statutory damages, operating the penalty as the minimum amount of damages.  

In sum, in spite of the common traits already mentioned, there are not uniform rules governing contract penalties in Continental Europe, and historically there has not been a real political will of unifying contract law within the European Union, even though some signs of change in 2010. These signs of change have led to a highly mature and innovative proposal of contract law harmonization, the Proposal for a Regulation on a Common European Sales Law, the scope of which are those aspects which pose real problems in cross-border transactions without extending to aspects that are best addressed by national laws. Notwithstanding, this Common

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42 German Civil Code (BGB § 341(1)).
43 ibid BGB §§ 340(2) and 341(2), both referring to the obligee’s assertion of additional damage in cases of non-performance and defective performance. Swiss law (Article 161-2 Code des obligations) also allows the recovery of the additional damage.
44 The European Union lacks a general legislative competence in contract law, since its competence is limited to those areas related to consumer protection, which has been extensively exercised (the so-called consumer acquis). The enactment of a European Civil Code may be perceived as an expression of European identity, but this view is conflicting with the widespread opinion that national codes reflect their own national legal values and legal cultures, factor which explains the political opposition to move towards to the unification of private law, Simon Whittaker, ‘The ‘Draft Common Frame of Reference’. An Assessment’ (2008) 23-4 <http://www.justice.gov.uk/publications/eu-contract-law-common-frame-reference.htm> accessed 15 May 2011. The origin of the Europeanization of private law has scholarly roots, since the 1980s academics from different European countries formed research groups to embark on the harmonization of private law. Despite the shy institutional support that firstly arrived from the European Parliament, the series of Resolutions from 1986 to 2003, the Commission on European Contract Law, chaired by Professor Ole Lando, elaborated the Principles of European Contract Law [hereinafter PECL], meant to provide black letter rules of soft law using the drafting style of a restatement rather than a code in the civil law meaning of the term, Ole Lando and huge Beale (eds), Principles of European Contract Law, Parts I and II, Combined and Revised (Kluwer Law International 2000); Ole Lando, Eric Clive, André Prüm and Reinhard Zimmermann (eds), Principles of European Contract Law, Part III (Kluwer Law International 2003). The second great achievement of this arduous process was the Draft Common Frame of Reference [hereinafter DCFR], commissioned by the European Commission, which combined rules from the PECL, rules from the existing European acquis, and rules from several teams of academics, Christian von Bar, Eric Clive and Hans Schulte-Nölke (eds), Principles, Definitions and Model Rules of European Private Law: Draft Common Frame of Reference (Sellier 2008). See also Luisa Antoniolli and Francesca Fiorentini (eds), A Factual Assessment of the Draft Common Frame of Reference (Sellier 2010) 7-10.
46 Commission, ‘Proposal for a Regulation of the European Parliament and of the Council on a Common European Sales Law’ COM (2011) 635 final. This proposal made by the Commission coincides with the widespread thinking according to which the most likely is that an European Regulation adopts, totally or partially, a harmonized body of rules as an optional instrument which contracting parties may choose as the applicable law to their contract in order to opt out of their national laws (the so-called ‘blue button’), Hans Schulte-Nölke, ‘EC Law on the Formation of Contract—from the Common Frame of Reference to the “Blue Button”’ (2007) 3 European Review of Contract Law 332, 348-49.
European Sales Law proposed by the Commission does not deal with contract penalties.

2.3. Case Law: Same Facts Leading to Different Outcome Across the Jurisdictions

An array of cases is presented in this Section in order to illustrate how much differ the three jurisdictions examined (United States, France and Spain) when adjudicating an issue involved in a dispute concerning an agreement for the payment of a fixed sum on breach of contract, regardless it is a liquidation of damages or a contract penalty. The issues discussed are the solutions to a disproportionate agreed sum, an unreasonably small agreed sum, and the promisee’s entitlement to both the agreed sum and specific performance.

2.3.1. Disproportionate Agreed Sum

In American state laws, parties are left in a climate of uncertainty because courts may tackle differently the single test of reasonableness. For instance, in Walter Implement, Inc. v. Focht, the Washington Supreme Court held that a liquidated damages provision requiring the 20% of the outstanding rental payments in a lease of farm equipment was unenforceable, although liquidated damages amounted to $8,645.06 and actual damages were approximately $15,000. In fact, the so-declared penalty, on the basis that the amount of liquidated damages was not reasonably related to the damages, and that the actual damages were easily ascertainable, showing a downward deviation of a 40%.

On the contrary, in Bruce Builders, Inc. v. Goodwin, the Court of Appeal of Florida upheld a liquidated damages provision under which the purchaser of eight lots of real estate for a total price of $173,800 forfeited the escrow deposit of $7,200, even though the seller made a net profit of approximately $2,500. In Bruce Builders, the Court of Appeal of Florida argued that the amount of liquidated damages did not shock the court’s conscience (the deposit was about the 4% of the total price), and that damages from breach were not ascertainable at the time of contracting.

In French law, despite the Civil Code (Article 1152), the judicial intervention is exceptional, provided that the penalty constitutes an abuse of the coercive function without justification. The Cour de cassation is prone to reverse those judgments...
from the appellate courts in which a penalty is declared ‘manifestly excessive’ and, accordingly, moderated insofar as no factual reasons are articulated to support the application of Article 1152. Nonetheless, Article 1152 may apply to reduce a disproportionate penalty on the grounds of equity; for example, the Cour de cassation affirmed the appellate court decision to reduce from €30,000 to €22,900 the penalty stipulated in a contract for the sale of a building under the condition precedent of obtaining a loan. Only €22,900 of the total amount of the earnest payment had to be forfeited, but the buyers claimed a larger reduction, which the Cour de cassation found to have been adequately denied due to their passive behavior, since the buyers had not met the deadline even after a two-years extension, in spite of the quick sale of the property at a good price.

On the other hand, the Spanish Supreme Court has even ruled that the fact that the sum stipulated is disproportionate or outrageous is irrelevant for a penalty to be reduced in the light of the Civil Code (Article 1154). The Supreme Court is also reluctant to endorse other legal grounds for the reduction of excessive penalties, in spite of the serious scholarly attempts to find alternatives out of the scope of Article 1154. In Spanish law, the earnest payments that operate bilaterally if any party breaches, i.e. the money is forfeitable by the recipient or the double amount is

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See n 32.

Article 1152 of the French Civil Code is often applied in conjunction with consumer protection rules, for instance, Cass 2e civ, 5 February 2009, Bull civ II, No 38 <http://www.legifrance.gouv.fr/initRechJuriJudi.do> accessed 10 March 2012. However, its wider scope embraces disputes in which the parties involved need not be consumers.


Nevertheless, the behaviors of the parties can never be the sole basis to hold a penalty manifestly excessive. See n 37.

Article 1154 of Spanish Civil Code (n 23). STS, 17 October 2007 (RJ, No 7307), the Spanish Supreme Court literally enforced the delay penalty included in a separation agreement, according to which the husband was entitled to €90.15 per day while his wife remains at the family home, leading to €72,211.60 due to 801 days of delay. See also STS, 29 November 1997 (RJ, No 8441), in a contract executed in 1988 and priced at 12,000,000 pesetas (€72,121.45), a defendant seller is bound to the property at a good price.

Alternative legal grounds that scholar have suggested to reduce excessive penalties are the following: (1) Article 1103 of the Spanish Civil Code, courts may moderate the contract liability arising from negligence on a case-by-case basis, Javier Dávila González, La Obligación con Cláusula Penal (Montecorvo 1992) 473, favoring this solution; whereas, Mas Badía (n 22) 229-30 argues that the stipulation of the contract penalty excludes the application of the general contract liability rules; (2) Article 1258 of the Spanish Civil Code, parties should perform their obligations in accordance with good faith, see n 38; (3) Article 1275 of the Spanish Civil Code, unjust enrichment, whenever there is an abuse of the coercive function or the penalty is not intended to coerce performance, Mas Badía (n 22) 232; (4) Article 7.2 of the Spanish Civil Code, abuse of rights, Mas Badía (n 22) 237; (5) rebus sic stantibus clause, the fulfillment of the contract becomes excessively burdensome due to unforeseen circumstances, Quesada González (n 38) 47, admitting the theoretical viability of this ground but stressing its highly unlikely application; Pablo Salvador Coderch, ‘Alteración de Circunstancias en el Artículo 1213 de la Propuesta de Modernización del Código Civil en Materia de Obligaciones y Contratos’ (2009) 4 InDret 8 <http://www.indret.com/pdf/687_es.pdf> accessed 10 March 2012, emphasizing that the application is still extremely restrictive under the tentative draft bill for the reform of the Spanish Civil Code (n 19) Article 1213. The Spanish Supreme Court has ruled about the application of some of the enumerated legal grounds to reduce excessive penalties, except good faith (Article 1258) and rebus sic stantibus clause, rendering inapplicable both unjust enrichment and abuse of rights, STS, 19 February 1985 (RJ, No 816), STS, 26 December 1990 (RJ, No 10374), and STS, 4 February 1991 (RJ, No 704). However, the Supreme Court exceptionally affirmed the reduction of an excessive penalty on account of Article 1103 in STS, 19 February 1990 (RJ, No 700).
returnable to the depositor, are considered penalties and, in consequence, those sums are subject to judicial reduction under Article 1154. Therefore, the Supreme Court held that Article 1154 was applicable to an earnest money agreement, but refused to moderate the 8,000,000 pesetas (€48,080,97) that the seller owed to the buyer because of the severity of the breach, the prior sale of the apartment to a third party.  

2.3.2. Unreasonably Small Agreed Sum 

In American state laws, the general rule is that the sum stipulated in a valid liquidated damages clause limits the liability arising from promisor's breach, having the aggrieved promisee no other remedy available for the recoverability of the portion of damages over the sum stipulated. Nevertheless, with respect to unreasonably small agreed sums, an exception is made on the basis of the unconscionability doctrine: term that fixes an unreasonably small amount as damages may be unenforceable as unconscionable. In this vein, in Roscoe-Gill v. Newman, the Court of Appeals of Arizona reviews an unreasonably small liquidated amount in the light of the unconscionability doctrine, even though the Court concludes that the facts alleged by the seller failed to render the liquidated damages clause unconscionable: in a contract for the sale of a ranch at $380,000, the buyer forfeited the $5,000 paid as earnest money in escrow in the event of default, while the seller sought excess damages that amounted to $140,000.

In French law, Article 1152 may also apply to increase a ridiculously low penalty ('dériseore peine') on the grounds of equity, as explained in Section I.2. In this

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61 Albeit the fundamental differences of the deposit, and the entitlement of the aggrieved party to claim the statutory damages exceeding the earnest payment, Silvia Díaz Alabart, 'Las arras (I)' (1996) 80 Revista de Derecho Privado 3, 37.
62 STS, 10 October 2006 (RJ, No 8405). See Jordano Fraga (n 23) 187, defending that Article 1154 is applicable to this kind of earnest money agreement; María Corona Quesada González, 'Estudio de la Jurisprudencia del Tribunal Supremo sobre las Arras' (2003) 5 Aranzadi Civil 8, against the application of Article 1154 to these agreements.
63 Perillo (n 11) 446. To illustrate the strict application of this general rule, see also Wechsler v Hunt Health Sys. 350 F Supp 2d 383, 426-27 (SDNY 2004), case in which the District Court declined to award early termination damages to the injured party in addition to the liquidated damages for the same concept.
64 Perillo (n 8) 534, arguing that granting the aggrieved party any other remedy, even contractually conferred by the party in breach, implies that a valid liquidated damages clause may not constitute a reasonable forecast of the harm.
65 A generally applicable doctrine in contract law, to which both Restatement (Second) of Contracts § 208 (1981) and UCC § 2-302 (1977) refer as a basis to hold unenforceable a contract term or all the contract. However, none of the provisions cited provides a definition of 'unconscionability', which has to be found in Williams v Walker-Thomas Furniture Co. 350 F.2d 445, 449 (DC Cir 1965), case in which the Court of Appeals stated that "[u]nconscionability has generally been recognized to include an absence of meaningful choice on the part of one of the parties together with contract terms which are unreasonably favorable to the other party'.
66 Restatement (Second) of Contracts § 356 cmt a (1981). Also, UCC § 2-718 cmt 1 (1977) explicitly welcomes the unconscionability doctrine in the realm of liquidated damages. See Hillman (n 8) 738, n 128, in favor of a validity inquiry on the grounds of the generally applicable doctrines of contract law such as unconscionability.
68 Plaintiff seller claimed as damages the $120,000 difference between the original sale price of $380,000 and the actual sale price of $260,000, plus $20,000 in interest and lost discounts, legal fees, and payments for taking care of the ranch.
69 Article 1152 (n 19).
regard, the Cour d’appel of Pau refuses to deem ridiculously low the penalty of €24,880 payable to the real estate agency for the breach of the exclusive right of sale, since this figure represents more than the 16% of the price at which the owners themselves sold the property (€152,400).\textsuperscript{70} In its lawsuit, the real estate agency claim additional damages amounting to €48,000 to compensate its financial loss.

Unlike French law, the governing principle of Spanish law is the literal enforcement of the contract penalty (Article 1152), with the only exception of partial performance,\textsuperscript{71} therefore courts are by no means allowed to increase an unreasonably small agreed sum. However, among Spanish legal scholars, the majority position has been to defend that the aggrieved party is entitled to be fully compensated whether the breach is willful instead of negligent, because of the prohibition to waive claims for damages arising from willful misconduct (Article 1102),\textsuperscript{72} would render the contract penalty unenforceable under such circumstances.\textsuperscript{73} Alternatively, a minority position of scholars has sustained another solution: regardless of Article 1102, the penalty is enforceable despite the willfulness of the breach, but the promisee is entitled to recover the excess damages.\textsuperscript{74} Anyhow, even if the breach is intentional, Spanish case law confirms the literal enforcement of the penalty, which bars the promisee’s claim to recover excess damages.\textsuperscript{75}

2.3.3. Promisee’s Entitlement to Both the Agreed Sum and Specific Performance

In American state laws, the validity of the ‘nonexclusive clauses’ is under discussion. ‘Nonexclusive clauses’ are those contractual provisions that entitle the promisee to the liquidated amount and any other remedy, either specific performance or the general compensatory damages. Nevertheless, the former combination deserves a different treatment than the latter.

With respect to specific performance, the nonexclusive clause has no effect, since the parties may not alter the restrictive availability of this equitable remedy, which can be granted by courts anyway, except the parties intended the liquidated damages to be the exclusive remedy for breach.\textsuperscript{76} In Stokes v. Moore, the Supreme Court of

\textsuperscript{71} Article 1154 of the Spanish Civil Code (n 23).
\textsuperscript{72} Article 1102 of the Spanish Civil Code: ‘La responsabilidad procedente del dolo es exigible en todas las obligaciones. La renuncia de la acción para hacerla efectiva es nula’ (‘Liability arising from willful misconduct is enforceable for all obligations. Waiver of the action to enforce it shall be null and void’).
\textsuperscript{73} Ángel Carrasco Perera, ‘Comentario al artículo 1.102 CC’ in Manuel Albaladejo García (dir), Comentarios al Código Civil y a las Compilaciones Forales, vol 15(1) (Edersa 1989) 444, 468, defending that Article 1102 forbids any agreed sum below the statutory damages; Ferran Badosa Coll, La Diligencia y la Culpa del Deudor en la Obligación Civil (Publicaciones del Real Colegio de España 1987) 718, claiming that the liability arising from intentional breach should always be aggravated.
\textsuperscript{74} Dávila González (n 59) 363, following the same understanding than José María Manresa, Comentarios al Código Civil Español, vol 7 (2nd edn, Imprenta de la Revista de Legislación 1907) 299. See also Rodríguez Tapia (n 22) 572-78, arguing that excess damages arising from any breach, intentional or negligent, should be recoverable.
\textsuperscript{75} The ruling of the Spanish Supreme Court since mid 80s, STS, 7 July 1998 (RI, No 5556), STS 20 February 1989 (RI, No 1212), and STS, 23 May 1997 (RI, No 4322).
\textsuperscript{76} Dobbs (n 14) 189-201, explaining the narrow scope of this remedy in American state laws.
Alabama enforces a $500 liquidated damages provision for the violation by an employee of a covenant not to compete against his employers in the city of Mobile for one year after the contract termination, and the Court also grants temporary injunctive relief, because of the finding that parties never intended liquidated damages as the sole remedy.\textsuperscript{77}

However, the aggrieved party will never be entitled to both the liquidated amount and the general compensatory damages. A stipulation with such content is held a penalty, because it is disproportionately beneficial for the promisee. For instance, in Schrenko v. Regnante, the Appeals Court of Massachusetts declared to be a penalty the clause that provided for forfeiture of a $16,000 deposit in the event of a buyers’ breach plus damages, in a failed contract for the sale of real estate in which the sellers received $25,000 more than the price the buyers would have paid.\textsuperscript{78}

In French law, the prohibition of the cumulative penalty controls, as explained in Section I.2.e), with the single exception of penalties for delay (Article 1129).\textsuperscript{79} Therefore, French courts will never grant to the aggrieved party both the penalty and the performance of the breached obligation. Logically, the Cour de cassation has ruled that this prohibition necessarily applies only with respect to the same obligation. In other words, if the promisor has breached two obligations, the injured promisse may claim the penalty arising from the breach of one obligation, and the performance of the other. For example, in a computer equipment lease contract, the Cour de cassation affirmed a judgment in which, in addition to the amount of unpaid rent, the lessee in breach was ordered to pay the agreed compensation in the event of termination.\textsuperscript{80}

On the contrary, in Spanish law, cumulative penalties are permitted (Article 1553),\textsuperscript{81} so the aggrieved party may be jointly entitled to the payment of the penalty and the performance of the obligation. Far from being the default rule, the high degree of coercion on the obligor and the wording of Article 1553 (‘unless this power has been clearly granted’) make that a cumulative penalty is never presumed. In this vein, if contract penalties, as an exception to the general rules of contract law, deserve a narrow interpretation, the interpretation of cumulative penalties should be even narrower. In accordance with this much stricter standard, the Spanish Supreme Court upheld as cumulative penalty a clause providing the additional payment of 15,000,000 pesetas (€90,151.82) in the event of delay or non-performance of the construction of two naves.\textsuperscript{82}

\section*{3. HOW TO SECURE THE ENFORCEMENT OF PENALTIES IN INTERNATIONAL COMMERCIAL CONTRACTS}

\textsuperscript{77} Stokes v. Moores 77 So 2d 331, 335 (Ala 1955): ‘the contract for liquidated damages will not operate to prevent an injunction . . . unless it appears from the contract that the provision for liquidated damages was intended to be the exclusive remedy for its breach’.

\textsuperscript{78} Schrenko v Regnante 27 Mass App Ct 282 (Mass App Ct.1989), buyers recovered the $16,000 deposit and sellers were not granted any compensation, since there was no loss at all, despite the sellers’ damages claim for $18,831.62 ($10,581.62 out-of-pocket expenses attributable to the buyers’ default, and the $8,250 difference in the commission paid to the broker).

\textsuperscript{79} Article 1229 of the French Civil Code (n 39).


\textsuperscript{81} Article 1153 of the Spanish Civil Code (n 40).

\textsuperscript{82} STS, 3 November 1999 (RJ, No 8859).
The General Assembly of the United Nations, when recommending the states to consider the adoption of the UNCITRAL Uniform Rules (1983), summarized with brilliance the reasons for the harmonization of the conflicting common law and civil law rules governing penalties in the sphere of international commercial contracts:

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,

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,

3.1. Indetermination or Failure of the International Instruments of Coordination: Treaties and Soft Law

Besides the UNCITRAL Uniform Rules, many other serious attempts have been made to broaden the enforceability of penalties in international trade, but nowadays there are no transnational rules that secure the enforcement of penalties in international commercial contracts. The lack of transnational rules in this area of law results from both the profound divergence between the civil and the common law traditions, and the relevant differences within the civil law countries.

The Benelux Convention on Penalty Clauses (1973) was the earliest and perhaps the most courageous of these attempts, despite being addressed solely to three signatory states (Belgium, Netherlands and Luxemburg), with very similar national laws, and all members of the same regional trade organization.

Afterwards, the question was deliberately skipped in the Vienna Convention (1980), the most successful treaty offering uniform commercial law rules. In my view, the CISG represented a lost chance to establish a path for the harmonization of contract penalties, given that its sphere of application is well-tailored (Article 1, ‘contracts of sale of goods between parties whose places are in different States’), and parties to a contract may exclude or vary its application (Article 6).

84 See n 41.
86 Of course, the legality of contract penalties was not a controversial issue. This Convention deals with other questions such as the statute of limitations (Article 7). See n 41.
Outside the domain of treaties, a wide variety of instruments have tackled this issue, however, none of them is legally binding for states, albeit potentially useful because parties may designate one of them as applicable law.

In the international arena, the UNCITRAL Uniform Rules (1983) were optimistically accompanied with a draft convention, mirroring the Vienna Convention,88 even though the UNCITRAL Uniform Rules were never adopted.89 The UNCITRAL Uniform Rules aimed to find a worldwide standard to balance the civil law enforceability, unless manifestly excessive, and the common law rule of unenforceability. The UNCITRAL Uniform Rules refer to ‘contract clauses for an agreed sum due upon failure of performance’ and non-sophisticated parties are excluded from its scope (Article 1),50 providing that these clauses are presumptively valid, so the judicial intervention may consist only in the reduction of the agreed sum if ‘substantially disproportionate’ with respect to the actual harm (Article 8).91 Nevertheless, the civil approach turned out to be predominant,92 as evidenced by the non-trivial dropping of the ‘genuine pre-estimate’ between the revised draft (Article G) and the definitive version (Article 8).93 For common law countries, the public policy concern against inequitable bargains together with the application by courts of two standards of justice, one for domestic and another for international transactions, or just the lack of interest may explain the failure of the UNCITRAL Uniform Rules.94

In the international arena too, the UNIDROIT Principles (Article 7.4.13),95 the major instrument of soft law in the field of international commercial contracts, have also

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89 Jonathan S Solórzano, ‘An Uncertain Penalty: A Look at the International Community’s Inability to Harmonize the Law of Liquidated Damages and Penalty Clauses’ (2009) 15 Law & Bus Rev Am 779, 813: ‘What is clear, however, is that somehow the proposal died. Model law or convention was ever adopted or entered into . . . The question we are left is why?’.
90 Article 1 of UNCITRAL Uniform Rules: ‘These Rules apply to international contracts in which the parties have agreed that, upon a 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’ (emphasis added).
91 Article 8 of UNCITRAL Uniform Rules: ‘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’.
92 Against, Larry A DiMatteo, ‘Enforcement of Penalty Clauses: A Civil–Common Law Comparison’ (2010) 5 Internationales Handelsrecht 193, 199, for whom the UNCITRAL Uniform Rules had a ‘middle ground approach’, arguing that “[b]y using the word ‘disproportionate’ the Rules adopt the disproportionate standard found in American law and provides a wider scope to the voiding or reforming of penalty clauses in the civil law’, statement which ignores the relatively higher familiarity with the term “disproportionate” or equivalent ones in civil law.
93 Solórzano (n 89) 811-12. Article G of UNCITRAL Revised Draft: ‘(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’. Nonetheless, already in the UNCITRAL Revised Draft, the prevailing view was that this element was not required for reduction, see UNCITRAL Revised Draft (n 41) 13, n 29.
94 Solórzano (n 89) 804 and 813-14. The general lack of interest is a highly plausible explanation, especially regarding the common law countries, since only eighteen countries responded when the UNCITRAL Draft was circulated, and only one of them was a true common law country (Canada).
95 International Institute for the Unification of Private Law, UNIDROIT Principles of International Commercial Contracts (1994) [hereinafter UNIDROIT Principles]. The Article dealing with contract penalties (7.4.13) has the same content in the 2004 version of the UNIDROIT Principles. Article 7.4.13
resolved the question following the civil law principle of enforcement of penalties subject to reduction:96 after giving an broad definition intended to include both liquidated damages and penalties,97 ‘agreed payment for non-performance’, the general rule is the recoverability of stipulated damages regardless of the actual harm (Article 7.4.13(1)), but the court may reduce those ‘grossly excessive amounts’ (Article 7.4.13(2)).

Within the European context, the scholar-made soft law rules of both the Principles of European Contract Law (Article 9:509),98 and the Draft Common Frame of Reference (Article III-3:712)99 stuck to the pattern set by the UNIDROIT Principles: stipulated damages are named again ‘agreed payment for non-performance’ in the PECL, or ‘stipulated payment for non-performance’ in the DCFR, and in the both texts the governing norm is the recoverability of the sum irrespective of the actual harm, unless the court finds it to be ‘grossly excessive’, case in which the sum will be reduced. The antecedent of them was the Council of Europe Resolution (78) 3,100 a set of eight non-binding rules that the member states were recommended to adopt in order to harmonize the civil law regimes.

The Council of Europe Resolution (78) 3, considered as a whole, contains much more detailed and elaborated rules than the soft law instruments examined until now (UNIDROIT Principles, PECL, and DCFR). Not only for using an inclusive definition of penalty (Article 1),101 and turning to the principle of enforcement of penalties subject to reduction (Article 7), but also for dealing with the prohibition of cumulative penalties (Article 2), and the compatibility of the penalty with claims for specific performance, statutory damages, and additional damages (Articles 3, 5 and 6). The impact on the current civil law codes was minimal, since most reforms of the national laws towards the aforementioned principle occurred years before,102 as described in Section I.2. Nonetheless, the Council of Europe Resolution (78) 3 might

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UNIDROIT Principles: ‘(1) Where the contract provides that a party who does not perform is to pay a specified sum to the aggrieved party for such non-performance, the aggrieved party is entitled to that sum irrespective of its actual harm. (2) However, notwithstanding any agreement to the contrary the specified sum may be reduced to a reasonable amount where it is grossly excessive in relation to the harm resulting from the non-performance and to the other circumstances’.

96 DiMatteo (n 92) 199.


98 See n 44. Article 9:509: ‘(1) Where the contract provides that a party who fails to perform is to pay a specified sum to the aggrieved party for such non-performance, the aggrieved party shall be awarded that sum irrespective of its actual loss. (2) However, notwithstanding any agreement to the contrary the specified sum may be reduced to a reasonable amount where it is grossly excessive in relation to the loss resulting from the non-performance and the other circumstances’.

99 See n 44. Article III-3:712: ‘(1) Where the terms regulating an obligation provide that a debtor who fails to perform the obligation is to pay a specified sum to the creditor for such non-performance, the creditor is entitled to that sum irrespective of the actual loss. (2) However, despite any provision to the contrary, the sum so specified in a contract or other juridical act may be reduced to a reasonable amount where it is grossly excessive in relation to the loss resulting from the non-performance and the other circumstances’.

100 See n 41.

101 Arana de la Fuente (n 41) 6.

102 Against, DiMatteo (n 92) 199, defending the influence of the Resolution in the later legislation regarding the generalization of the ‘manifestly excessive’ standard and the preference for reformation or reduction of the stipulated damages.
be viewed as the European civil law model of contract penalties, given that the main characteristics of European civil laws are captured: (1) the validity of contract penalties, which may have the effect of coercing a party to perform her obligation; (2) the judicial review of penalties on the grounds of equity as a discretionary faculty, based on a retrospective test considering the actual harm, or on the grounds of partial performance; and (3) the promisee’s entitlement either to the penalty or to specific performance, with the exception of delay.

3.2. Fighting Uncertainty: Contractual Arrangements for the Enforceability of Penalties and their Effectiveness

The lack of transnational rules that control the enforceability of penalty clauses in international commercial contracts, as shown in Section II.1, puts at risk the will of the contracting parties. In addition to this lack of transnational rules, the absence of coordination instruments among the several jurisdictions at a national level entails that parties are unable to secure the enforceability of contract penalties by resorting to the available contractual devices, such as choice of law, forum selection, and arbitration clauses. These contractual arrangements might turn out to be ineffective for several reasons, in particular whether the enforcement of the penalty is sought in common law courts, either adjudicating the dispute or executing the judgment or the arbitration award, since the mandatory rules against penalties might never be displaced.

Obviously, the effectiveness of these contractual arrangements is likely to be higher when parties have chosen a civil law, and the court involved in adjudication or execution is also a civil law one, since general policy considerations that may render the penalty void will not arise so long as lex contractus and lex fori belong to the same legal tradition. For instance, if parties designate Spanish law as applicable, and the selected forum is Chile. Within the European Union, the effectiveness of these clauses is even higher, due to the general rules of international private law in the area of contracts, which even allow that parties derogate from certain mandatory rules. As an illustration, if parties decide to severely limit contract liability by using a penalty clause with an unreasonable small agreed sum, Italian law may be the applicable law designated to trump the French Civil Code (Article 1152) when the

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103 Besides transnational rules, coordination instruments might also be unilaterally provided by purely national rules, for instance, by granting the application of the foreign penalty law designated by the parties, or by granting the execution of a foreign judgment or arbitral award.

104 Pure drafting techniques intended to increase the chances of enforceability of penalty clause if a common law regime is applicable are not considered here, because these techniques are not capable to provide a minimum level of certainty under the case-by-case approach and the selective enforcement of stipulated damages. See n 7. See also DiMatteo (n 91) 200-01, making useful suggestions for drafting a penalty clause under American state laws.

105 Farnsworth (n 1) 812, n 5, fearing that soft law may not derogate from this common law prohibition, albeit designated as applicable law by the parties: ‘Whether this provision [Article 7.4.13 UNIDROIT Principles] can have any effect on a mandatory rule such as the common law rule prohibiting penalties is an open question’.

106 In the example, the parties of an international commercial contract intended the literal enforcement of the agreed penalty, avoiding the objective limit for pecuniary obligations imposed by the Chilean Civil Code (Article 1544), i.e. the penalty may not exceed the double of the value of the undertaking not performed.

selected forum is France in order to prevent the judge from increasing a ridiculously low penalty ('dérisoire peine') on the grounds of equity. The Rome I Regulation (Articles 3.3 and 9.1)\(^\text{108}\) grants this possibility — only the 'overriding mandatory provisions' of the law of forum will resist the law chosen by the parties. In this regard, this French rule is mandatory,\(^\text{109}\) but it can hardly be deemed an 'overriding mandatory provision' in accordance with the law of the European Union.

Conversely, the effectiveness of these contractual arrangements is uncertain when the parties intended to avoid the common law prohibition of penalties, and the court deciding the case or executing the foreign judgment or arbitral award is a common law court. The likelihood of success increases in the next order: (1) only a pro-penalty choice of law, (2) a pro-penalty choice of law in conjunction with the selection of a civil law forum, and (3) a pro-penalty choice of law and arbitration in a civil law country, which is the safest way to secure the enforcement of penalties in international commercial contracts.\(^\text{110}\)

However, considering the third solution to secure the enforcement of penalties in common law jurisdictions, one may doubt whether the enforcing court would refuse the recognition and enforcement of the arbitral award, since even the New York Arbitration Convention\(^\text{111}\) grants this refusal if the recognition or enforcement would be contrary to the public policy of that country (Article V(2)(b)).\(^\text{112}\) This ground under the New York Arbitration Convention casts doubt on the enforcement of an arbitral award in common law countries, in particular, in the United States, one of the jurisdictions analyzed here. Absent any decision from an American court, there is not a definitive answer to this question yet. Nevertheless, in accordance with the case law from another common law jurisdiction, the award would be enforced.\(^\text{113}\)

\(^{108}\) Article 3.3 of Rome I Regulation: ‘A contract shall be governed by the law chosen by the parties. The choice shall be made expressly or clearly demonstrated by the terms of the contract or the circumstances of the case. By their choice the parties can select the law applicable to the whole or to part only of the contract’. Article 9.1 of Rome I Regulation: ‘Overriding mandatory provisions are provisions the respect for which is regarded as crucial by a country for safeguarding its public interests, such as its political, social or economic organisation, to such an extent that they are applicable to any situation falling within their scope, irrespective of the law otherwise applicable to the contract under this Regulation’. See Ana Quiñones Escámez, ‘Ley Aplicable a los Contratos Internacionales en la Propuesta de Reglamento “Roma I” de 15.12.2005’ (2006) 3 InDret 16-7 <http://www.indret.com/pdf/367_es.pdf> accessed 15 March 2012, explaining the origin and evolution of the concept of overriding mandatory provisions (leyes de policía) in the case law of the Court of Justice of the European Communities.

\(^{109}\) Article 1152 of the French Civil Code (n 19), providing that ‘[a]ny stipulation to the contrary shall be deemed unwritten’.

\(^{110}\) DiMatteo (n 92) 200, sharing the same view in this regard, despite a more pessimistic opinion about the execution of the award in the United States.

\(^{111}\) Convention on the Recognition and Enforcement of Foreign Arbitral Awards (1958) 21 UNST 2518 ['hereinafter New York Arbitration Convention']

\(^{112}\) Article V(2)(b) of the New York Arbitration Convention: ‘Recognition and enforcement of an arbitral award may also be refused if the competent authority in the country where recognition and enforcement is sought finds that . . . (b) The recognition or enforcement of the award would be contrary to the public policy of that country’.

\(^{113}\) Dirk Otto and Omaia Elwan, ‘Article V(2)’ in Herbert Kronke et alii (eds), Recognition and Enforcement of Foreign Arbitral Awards. A Global Commentary on the New York Convention (Kluwer Law Internantional 2010) 345, 401 n 268, referring to a very recent Hong Kong court decision ruling that the Danish arbitration award providing for overcompensatory liquidated damages does not violate public policy, A v R [2009] HKCFI 342 (Court of First Instance of the High Court, Hong Kong). Against, DiMatteo (n 92) 200, sustaining that the award is likely to be questioned by American courts.
An additional precaution that might be taken, as DiMatteo cleverly suggests,\textsuperscript{114} is the prepayment of the penalty by means of an escrow account within the jurisdiction of the selected civil law forum, or within the same civil law country agreed for the arbitration. Notwithstanding, the contract may provide several penalties or penalties of a considerable amount, then none of the potential breaching parties will be prone to deposit the full amount of the penalties stipulated in the contract. Therefore, albeit the payment of the potentially due penalty is not completely secured, the deposit in the escrow account secures at least the partial payment, acting as well as a powerful incentive to ensure performance.

3.3. A Quick and Safe Solution: To Shield the Enforcement of Penalties in International Commercial Contracts in Common Law Jurisdictions

After having examined prior attempts for the harmonization of the conflicting common law and civil law rules governing penalties, the main reason of the failure of all these harmonization projects (treaties or bodies of soft law) has always been that the root principles of each legal tradition are not compatible, therefore the adoption of one root principle necessarily supersedes the other. In this regard, treaties and bodies of soft law have usually opted for the principle of enforcement of penalties subject to reduction, the civil law principle, a choice that has involved the understandable rejection of common law countries.

Under this dilemma, the demand of legal certainty in the field of enforcement of penalty clauses by the actors in international trade points to a relatively easy response: shielding the enforcement of penalties in international commercial contracts in common law jurisdictions by means of their statutory recognition at national level. Statutory recognition at national level that should be narrowly tailored to penalties expressly agreed by the parties in contracts in which at least one party is non-national, and the choice of law designates a foreign law according to which penalties are permissible.

In my opinion, the proposed solution is the most feasible for the enforceability and effectiveness of penalties in international commercial contracts because (i) it would be unilaterally adopted by each single common law jurisdiction, which implies that it has no coordination costs and that its success does not depend on an agreement among a high number of states; and (ii) it would be legally binding, which of course means a stronger effect than an optional regime designed in a body of soft law.

Nevertheless, there exists the well-founded fear of the rejection of the proposed solution by the legislatives of the common law countries, since it would lead to the application of two standards of justice, one for domestic and another of international transactions. This reasoning was one of the grounds to turn down the UNCITRAL Uniform Rules.\textsuperscript{115}

4. CONCLUSION

After having explored the clash between the civil and the common law traditions, and the existing disparities among civil laws in the field of penalty clauses, this paper

\textsuperscript{114} ibid 202.

\textsuperscript{115} Solórzano (n 89) 804 and 813–4.
urges the adoption of transnational rules to secure the enforcement of penalty clauses in international commercial contracts in order to provide the actors in international trade with the certainty that they demand.

The international community acknowledged this need three decades ago, when the first UNCITRAL Draft was submitted in 1981, but the final UNCITRAL Uniform Rules and other harmonization projects have failed in that respect. Basically, the reasons that might explain this failure are two: on the one hand, all these projects have always aligned with the civil law legal tradition — in particular, the UNCITRAL Uniform Rules —; and, on the other hand, common law countries are unwilling to give up the prohibition of penalties, and tend to be prejudiced against the enforcement of penalties, even when the parties to a contract are merchants.

In the absence of coordination instruments among the several jurisdictions, the will of the contracting parties is at risk. Nevertheless, this lack of transnational rules is much more detrimental for the parties if a common law jurisdiction is involved. Not only civil law jurisdictions usually do not present sharp differences, but also the effectiveness of the contractual arrangements (choice of law, forum selection and arbitration clauses) is generally higher, especially within the European Union. On the contrary, whether a common law jurisdiction is involved, parties can only fight uncertainty by incurring substantial transaction costs to secure the enforcement of contract penalties, since all the available contractual devices have to be employed to diminish the likelihood of unenforcement. In this second scenario, the contractual toolkit may turn out to be insufficient, and therefore the need of transnational rules to bridge the gaps between civil and common law systems becomes critical.

Nevertheless, from a practical point of view, given the failure of all the attempts of the international community in the field of the enforcement of penalties, a quick and safe solution is the shielding of the enforcement of penalties in international commercial contracts in common law jurisdictions by means of their statutory recognition at national level. This recognition in each state would be restricted to penalties expressly agreed by the parties in contracts in which at least one party is non-national, and the choice of law designates a foreign law according to which penalties are permissible. Paradoxically, despite the need of transnational rules in this realm, the most feasible solution consists of the approval of national rules of limited scope but amazingly positive effects in international trade.