ANNEX

Draft rules on liquidated damages and penalty clauses
adopted by the Working Group*

SCOPE OF APPLICATION

Draft rule 1

"These rules apply to an international 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."*  

Draft rule 2

"Unless the parties have agreed otherwise, the obligee is not entitled to recover or to forfeit the agreed sum if the obligee is not liable for the failure of performance."

REGULATION OF THE CONTRACT BY THE RULES

Draft rule 3

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

* Changes have been made in the text of draft rules 2, 3 and 4 to ensure consistency in terminology.

* For additional provisions which might be required, see para. 48 above.

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."

Draft rule 5

"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."

Draft rule 6

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."  

Draft rule 4 submitted by the Secretariat to the first session of the Working Group was deleted by the Working Group at that session. No rule 4 was included in the revised draft rules submitted to the second session of the Working Group. In order to facilitate comparison with the draft rules submitted to the first session, the numbering of revised draft rules 5 and 6, which correspond to draft rules 5 and 6 submitted to the first session, have been retained.


CONTENTS

<table>
<thead>
<tr>
<th>PARAGRAPHS</th>
</tr>
</thead>
<tbody>
<tr>
<td>1-7</td>
</tr>
</tbody>
</table>

INTRODUCTION .................................................................................................................. 1-7

PART I. The manner in which liquidated damages and penalty clauses are drafted and used in various types of international contracts ................................................................. 8-50
A. Possible scope of Rules applicable to such agreements ............................................ 10-20
B. The accessory nature of such agreements ................................................................. 21-27
C. The relationship between the right to obtain performance of a contractual obligation and performance of agreements accessory to it ................................................................. 28-39
D. The relationship between the right to obtain performance of the accessory obligation and damages for breach of the contractual obligation to which it is accessory .................................................. 40-46
E. Limitations on the freedom of the parties to stipulate a sum of money by way of penalty, and the power of courts and arbitral tribunals to modify the amount of the sum stipulated ........................................................................................................... 47-50

PART II. The particular types of international trade contracts which might usefully be regulated by uniform rules ................................................................. 51-58

PART III. The legal difficulties encountered in the use of liquidated damages and penalty clauses, as shown by court and arbitral decisions ........................................................................ 59-70

PART IV. Revised set of draft Rules ................................................................................. 71-85

* 12 February 1981.
Introduction

1. At its twelfth session (1979) the United Nations Commission on International Trade Law requested its Working Group on International Contract Practices to consider the feasibility of formulating uniform rules on liquidated damages and penalty clauses applicable to a wide range of international trade contracts.

2. Pursuant to this request, the Working Group held its first session at Vienna (24-28 September 1979). At the conclusion of its deliberations, the Working Group was of the view that further work on the subject of liquidated damages and penalty clauses was justified, and recommended to the Commission the holding of a further session of the Working Group. It was also of the view that the Secretariat should submit to that session a further study focusing on the following issues:

(a) The manner in which liquidated damages and penalty clauses are drafted and used in various types of international trade contracts;

(b) The particular types of international trade contracts which might usefully be regulated by uniform rules;

(c) The legal difficulties encountered in the use of liquidated damages and penalty clauses, as shown by court and arbitral decisions.

3. The Working Group also authorized the Secretariat to submit to the next session a revised set of draft rules for regulating liquidated damages and penalty clauses, if the further work of the Secretariat disclosed the desirability of drafting such a revised set of rules.

4. At its thirteenth session, the Commission adopted the recommendation of the Working Group, and requested the Working Group to hold a further session.

5. The present report is submitted in pursuance to the request of the Working Group. It examines the issues noted at sub-paragraphs (a), (b) and (c) of paragraph 2 above, and contains a revised set of draft rules. While the emphasis in the earlier report of the Secretary-General on liquidated damages and penalty clauses was on the manner in which various legal systems approached such clauses, and the obstacles to unification presented by these differing approaches, the present report concentrates on current experience in the use of liquidated damages and penalty clauses in international trade contracts. Apart from examining contracts, arbitral awards and judicial decisions, attention has also been directed to the provisions regulating liquidated damages and penalties in laws and general conditions for delivery intended to regulate international trade, and at existing attempts at unification in regard to liquidated damages and penalties.

6. The Secretariat also solicited the views of selected experts with experience in international contract practices, and these views are reflected in the report where relevant. Furthermore, at the request of the Secretariat, a questionnaire relating to the relevant issues was circulated by the International Chamber of Commerce to its national committees, and the responses received are summarized in Addendum I to this report.

7. In the analysis that follows, the term "main obligation" will be used to describe the obligation, breach of which entails the payment of liquidated damages or a penalty, while the term "accessory obligation" is used to indicate the obligation to pay liquidated damages or a penalty; and the term "promisor" is used to indicate the party under a duty to pay liquidated damages or a penalty, while the term "promisee" is used to indicate the person entitled to claim the liquidated damages or penalty.

Part I. The manner in which liquidated damages and penalty clauses are drafted and used in various types of international trade contracts

8. The basis for the study of this issue was the Secretariat collection of contracts. In the examination of contracts made for the purposes of the previous report, attention was directed primarily to printed clauses found in general conditions, and it was noted that firm conclusions could not be drawn from these clauses, as the printed text may be amended or rejected before the conclusion of a contract. Furthermore, available general conditions only dealt with a few types of contract.

---


4 A/CN.9/177, para. 42 (Yearbook . . . 1980, part two, II). A set of rules drafted by the Secretariat was submitted to the Working Group.


7 This collection at present comprises a few hundred contracts and contract clauses. The material has been supplied to the Secretariat primarily by Governments. It is not restricted, however, to contracts in which a Government or Governmental enterprise is a party. The collection includes many contracts between enterprises in developed and developing countries, and also some contracts between enterprises from the Socialist States of Eastern Europe and enterprises from Western Europe and the United States of America. Examples of the following types of contracts were examined: sales (machinery, agricultural produce, general merchandise), construction, maritime transport, licensing, loans, service and leasing, mining and mineral prospecting agreements, distributorship, joint ventures, and project financing. Sample liquidated damages and penalty clauses, where the contract from which the clause was extracted was not made available, were also examined.

the purposes of the present study, only clauses in concluded contracts have been examined. However, the present study did not reveal any reason to doubt the tentative conclusions reached in the earlier study.

9. In view of the work already done by the Working Group, the contracts and clauses were examined primarily for the following purposes: to determine whether international contract practices in regard to liquidated damages and penalty clauses indicated possible solutions to the difficulties experienced by the Working Group at its first session, and to determine whether such practices presented features which needed to be taken into account when formulating uniform rules. It is therefore convenient to present the findings in their relation to the main issues as embodied in the draft Rules considered at the first session of the Working Group. As requested by some members of the Working Group, examples of clauses from contracts are given where appropriate, illustrating the formulations and devices used by traders.

A. **Possible Scope of Rules Applicable to Such Agreements**

10. **Draft Rule 1**

These Rules apply where the parties to a contract have agreed (in writing) that, in the event of failure by the promisor (debtor) to perform his obligation, or a specified obligation, under the contract, he will pay to the promisee (creditor) or forfeit to him a sum of money (or perform a specified act) (whether by way of compensation or penalty or both).""

11. The Working Group decided that the Rules should apply to agreements in international trade contracts, irrespective of whether such agreements envisaged the payment of a sum of money by way of compensation for loss suffered, or by way of penalty in order to coerce the debtor to perform.\(^9\) The present study confirmed the soundness of this decision. 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 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.

Illustration:

"Penalty for delay"

"With the exception of force majeure causes involving extension of period as set forth under . . . . . . below, if there should be any delay in FOB delivery of . . . . . . . . . . . , a compensation of delay will be withheld from the supplier's 10% balance, . . . . . . . . . . . . . . (Emphasis added.) (Contract for sale of pneumatic plants by West European enterprise to Asian enterprise.)"

12. The wish of the parties at the time of the conclusion of the contract is to ensure that payment of the agreed sum, however it is classified, is enforceable.

Illustration:

"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." (Contract for sale of equipment by North American enterprise to foreign enterprise.)

13. The Working Group also decided that the Rules should only regulate cases where parties had agreed that, in the event of failure by the promisor to perform the main obligation, the accessory obligation should entail payment or forfeiture to the promisee of money, and should not regulate cases where the accessory obligation entailed something other than the payment or forfeiture of money.\(^11\) This restriction on scope appears to be justified, as the only clauses revealed by the study were for the payment or forfeiture of money.

14. The Working Group was agreed that the Rules should be applicable, not only to cases of a promise to pay, or forfeiture of, a sum of money on total failure by the promisor to perform his obligations, but also to cases where the breach consisted of defective or partial performance.\(^12\) This decision is supported by the fact that in many cases it was difficult to determine whether the breach in respect of which the liquidated damages or penalty is payable is to be construed as a case of total or partial failure of performance.

**Contract Usage Relevant to the Formulation of the Rules**

15. **When the Promisor’s Duty to Pay Arises**

Examples were found where the duty to pay the agreed sum was activated, not by the promisor's breach of contract, but by the act of a third party to the contract:

Illustration:

"In the event that:

"(a)-(f) . . . . . . . .

"(g) The third party or any Agency acting as an instrument thereof ceases at any time to be the

---

\(^9\) A/CN.9/177, paras. 14-19 (Yearbook . . . 1980, part two, II). The issue as to what types of international trade contracts the Rules might cover (A/CN.9/177, para. 15) is considered in Part II below.


\(^12\) A/CN.9/177, para. 19 (Yearbook . . . 1980, part two, II).
proprietary of or to control the share capital of the Borrower or Guarantor;

"(h) . . . .

"In this event the Agent may, by notifying the Borrower,

“(1) Where the credits have been advanced, declare as immediately due and payable the principal and the interest on the Loan and the Promissory Notes, as a result of which they shall immediately become due and payable.” (Contract of loan by consortium of foreign banks to Latin American firm.){13}

16. The agreed sum

In most cases parties agreed not on the sum payable but on a formula for determining the sum payable depending on the circumstances of the breach. The value of the clause will depend on the extent to which it involves potentially disputable facts.

17. Mechanism for payment of agreed sum

The Rule as presently drafted contemplates a direct payment by the promisor to the promisee{14}, or a forfeiture of a sum of money to the promisee. In many cases, however, the mechanism adopted for payment was to give the promisee the right to call for payment from a financial institution which had issued a bond in favour of the promisee.{15} Furthermore, forfeiture was found to include not merely cases of the appropriation of money already paid by the promisor to the promisee,{16} but also the loss of the right to unpaid money due from the promisee to the promisor.

Illustration:

“If there should be a delay in delivery of machines, equipment, installations and materials involved in the Plant as committed by Firm, a sum of . . . . will be withheld from Firm’s claims or Performance Bond for each calendar day delayed.” (Contract for sale of chemical plant by West European enterprise to Asian enterprise.)

18. Examples were found when the forfeiture was of sums due under other contracts between the same parties.

Illustration:

“The penalties or charges which may be provided shall apply, successively and up to the limit specified in the preceding paragraph, to invoices arising out of the contract which may be in the process of collection or transaction; to those arising out of another contract which may have the same status, in all cases within the scope of the ENTERPRISE; to any other credit which the SELLER may have in the remaining constituent parts of the ENTERPRISE; and, lastly, to the relevant guarantee.” (Emphasis added.) (Contract for sale of machinery by West European enterprise to Latin American enterprise.)

19. Defining what constitutes liquidated damages and penalty clauses

In the earlier report, attention was directed to certain clauses which, although differing in form from liquidated damages and penalty clauses, nevertheless approximated to them by serving the same purposes.{17} In the present survey, examples were found of clauses providing for acceleration of payments{18} (see illustration to paragraph 15 above), and forfeiture clauses{19} (see illustration to paragraph 17 above). The function that liquidated damages and penalty clauses serve as limitation clauses{20} was clearly brought out by several contracts which established a graduated scale of payments for delay in performance not exceeding a maximum amount.{21} Examples were also found of clauses where sums described as liquidated damages were payable although the acts of the promisor upon which the sums were payable did not constitute a breach.

Illustration:

“It is further agreed that this arrangement and all rights and obligations hereunder may be terminated by (Seller) at any time for any reason which it, in its sole discretion, deems desirable, provided, however, that, except in the case of default in performance by Distributor, Seller gives at least 30 days notice of its intention to do so to Distributor. Commission earned during the notice period, if and when notice is required, shall be liquidated damages resulting from said termination.” (Contract between North American enterprise and foreign enterprise.)

A clause of this type may perhaps be regarded as the price payable for the exercise of an option. (See also paragraph 65 below.){22}

---

{13} Such a clause derivates from the traditional conception of a liquidated damages clause as constituting an accessory obligation. See also A/CN.9/161, para. 10 (Yearbook . . . 1979, part two, I, C), and paragraph 19 below.

{14} See also the following: “A penalty clause shall mean any clause according to which the debtor, if he fails to perform his obligation, shall be required, by way of penalty or compensation, to pay a sum of money or perform some other act.” (Emphasis added.) (Article 1 of the common provisions annexed to the Benelux Convention relating to the Penal Clause, done at The Hague on 26 November 1973.)

{15} Formally, the payor will be the financial institution, although it will recover the money from the promisor.

{16} As forfeiture was envisaged in A/CN.9/161, para. 11 (Yearbook . . . 1979, part two, I, C).

{17} A/CN.9/161, paras. 7-12 (Yearbook . . . 1979, part two, I, C).

{18} A/CN.9/161, para. 10 (Yearbook . . . 1979, part two, I, C).

{19} A/CN.9/161, para. 11 (Yearbook . . . 1979, part two, I, C).

{20} A/CN.9/161, para. 12 (Yearbook . . . 1979, part two, I, C).

{21} See also the following: “However, the total amount of the penalty for delay in delivery may not exceed 8 per cent of the value of the goods in relation to which the delay took place.” (Article 83 (3) of the CMEA General Conditions of Delivery, 1968-1975.)

{22} Such a clause deviates from the traditional conception of a liquidated damages clause as constituting an accessory obligation (see paras. 21 and 22 below).
20. For the purpose of formulating a rule on this issue, some decisions would have to be taken on the desired scope of the Rules, and in particular as to the types of clauses to be regulated.

B. THE ACCESSORY NATURE OF SUCH AGREEMENTS

21. Draft rule 2

"Unless the parties have agreed otherwise, the promisee is not entitled to enforce the agreement if the promisor is not liable for his failure to perform the obligation (is not in breach of his obligation) to which the agreement relates."23

22. The Working Group was generally agreed on the substance of this rule, which accords with the rules of most national legal systems. However, no contract clauses were found laying down such a rule in general terms. The normal approach adopted was to link the liability to pay the liquidated damages or a penalty to the excuses for non-performance of the main obligation specified in the contract. These specified excuses were normally circumstances defined as constituting force majeure, but circumstances constituting casus fortuitus, and acts imputable to the promise leading to the promisor's inability to perform the main obligation were sometimes included.

Illustration:

"Neither ... nor ... shall be liable to any of the penalties mentioned in clause 14.1 or for any delay in the performance of their obligations under the present contract if such delay was due to causes attributable to 'THE ENTERPRISE' or to force majeure or casus fortuitus as indicated in clause 18." (Contract for the supply of electrical machinery by a foreign consortium to a Latin American enterprise.)

23. The effect of the operation of an excuse for non-performance of the main obligation was sometimes the cessation of the obligation to pay the liquidated damages or penalty, but was often a modification of the latter obligation to parallel a modification of the former:

Illustration:

"In the event of the occurrence of circumstances in the nature of force majeure which make it impossible for the Seller's contractual obligations to be performed, the Seller shall be entitled to extend the delivery period for a reasonable length of time or to cancel the contract, without in any case making himself liable to any kind of indemnification." (Contract

24. All contracts examined contemplated that the accessory obligation would become immediately enforceable on breach of the main obligation without the need for any further formalities by the promisee, and a few contracts expressly provided for this:

Illustration:

"Automatic penalties: The penalty indicated in clause 14.1 shall be applied automatically and without it being necessary to give advance notification in writing, and the delay shall be considered as having been incurred by the mere lapping of the time limit, without any judicial or extra-judicial appeal being necessary." (Contract between a Latin American enterprise and a foreign consortium for the supply by the latter of electrical equipment.)

25. When examining contracts in relation to this issue, it was observed that a penalty clause needed to be evaluated in the context of the whole contract. For example, while one party may negotiate the insertion of a heavy penal sum in the contract, the other may negotiate the insertion of such wide excusing circumstances in regard to performance of the main obligation that the penalty would rarely fall due.

26. Exceptional cases

A few cases were found where agreed sums were payable by the promisor despite the fact that there was no breach of contract on his part. (See paragraphs 15 and 19 above.)

Conclusions

27. Most of the contracts examined reflect the principle contained in the rule under consideration. Decisions to be taken as to the types of clauses to be regulated by the Rules (see paragraph 20 above) will determine how the exceptional cases are to be treated.

C. THE RELATIONSHIP BETWEEN THE RIGHT TO OBTAIN PERFORMANCE OF A CONTRACTUAL OBLIGATION AND PERFORMANCE OF AGREEMENTS ACCESSORY TO IT

28. Draft Rule 3

"(1) Unless the parties have agreed otherwise, the promisee is not entitled to enforce the agreement if he requests performance of the obligation to which the agreement relates.

24 See, however, the following: "A creditor who demands the enforcement of the penalty clause must make a request or a statement beforehand in cases where such a request or statement would be required in order to obtain the damages and interest due under the law." (Article 3 of the common provisions annexed to the Benelux Convention relating to the Penal Clause, done at The Hague on 26 November 1973.)"
"(2) The provision of paragraph (1) of this Rule does not apply if the agreement relates to delay in performance."

Variant to draft Rule 325

"Payment of an agreed sum does not exempt the promisor from performance of the obligation, for breach of which he has paid the agreed sum, unless the parties had agreed otherwise."

29. Differences of view within the Working Group

Different opinions, as reflected in paragraph (1) of draft Rule 3 above, and the variant to it, were expressed on the extent to which the promisee should be entitled to claim performance both of the main obligation and the accessory obligation. Under one view, cumulative enforcement of both obligations would be harsh to the promisor, and result in unjust enrichment of the promisee. On another view, performance of the main obligation was of paramount importance to the promisee, and only enforcement of performance of the main obligation together with the payment of compensation for loss caused by defective performance, could adequately protect him. However, it is submitted that this sharp conflict may not present such serious difficulties as may appear at first sight if attention is directed to the function of the agreed sum in the particular clause. As shown below, either one of the different solutions noted above could be appropriate depending on the circumstances in question.

30. Agreed sums payable for delay

There was general agreement, however, that in the case of agreed sums payable for delay in performance, payment of the agreed sum did not release the promisor from performance of the main obligation. Although no contract examined was at variance with this principle, an explicit recognition of the principle (as in the illustration below) was rarely found.

Illustration:

"If the Contractor fails to complete the project in accordance with the Specifications and Drawings and within the time fixed by the Project Implementation Schedule or any extension of such time as provided under clause . . . . the Contractor shall pay the [buyer] . . . . per day from the stipulated Date of Completion until such date when the project is completed satisfactorily subject to a maximum of 10% of the total contract price stated in clause 4." (Emphasis added.) (Contract for supply of equipment by foreign enterprise to South East Asian enterprise.)

31. In such cases, cumulation of both the right to the agreed sum and to performance results logically from the fact that the agreed sum is only intended to compensate the promisee for the loss he suffers during the period between the start of delay and ultimate performance.26

32. The agreed sum, which normally varied with the extent of delay, was subject to a maximum, and when delay continued to a point after which performance was not required by the promisee, other remedies were often provided.

Illustration:

"However, penalty period will not exceed half of the total delivery period stipulated under article 4 above, and if exceeded, then the (buyer) will be free to cancel the contract, but it can extend the penalty period for a further two months, if it so desires. In case of (seller's) failure to fulfill its obligation within this period too, contract will be cancelled and Performance Bond confiscated by (buyer)." (Contract for supply of pneumatic plants by West European enterprise to Asian enterprise.)27

33. Agreed sums payable for defects in performance

While agreed sums payable for delay were found frequently, agreed sums payable for defects in performance were rarely found.28 The extent to which sums payable for defects could be claimed together with proper performance appeared to depend on the function intended to be served by the sum.

(i) Price reduction

34. Where the sum payable was intended as a price reduction, so as to cause an equivalence between the new price to be paid and the imperfect performance, proper performance could not additionally be claimed.

Illustration:

"If, in accordance with the terms of article 11.2, it proves impossible in the course of repeated tests to achieve the guaranteed values, the Buyer shall be entitled to claim only a reduction in the price of the machine in question equal to 1 per cent for every full percentage point of failure of the guaranteed value over the limits of the agreed or customary tolerance, provided that the total rebate shall not exceed 5 per cent of the price of the machine in question." (Emphasis added.) (Contract for sale of electrical machinery by East European enterprise to Latin American enterprise.)29

25 See paragraph 67 below.
26 For the right to recover a penalty stipulated for delay when the delay continues indefinitely, see paragraph 63 below.
28 It would also be reasonable to provide for a penalty covering losses incurred during the period between the time a claim in respect of defects is made and the time when agreement on a price reduction is reached, where the scope of the price reduction is limited to producing an equivalence between the price to be paid and the defective performance. An example is provided in article 75, paras. 4 and 5 of the CMEA General Conditions of Delivery 1968-1975.
29 In the cases included in paragraph 3 of this article, the buyer shall be entitled, provided that the merchandise cannot be used in the
(ii) Cure of defect

35. A contract might provide that the party receiving defective performance is entitled to require the other party to cure the defective performance. In such a case, if an agreed sum is provided to cover losses occurring in the period elapsing between the time the cure is requested and the cure is effected, payment of the agreed sum would not release the promisor from making proper performance by effecting the cure.

Illustration:

“In the event Seller does not make warranty replacement or repairs within 5 (five) working days from receipt of notice, Seller shall pay a penalty of 1 (one) per cent per week or any part of a week commencing after expiration of said 5 days . . . .

“In case when warranty defect is not or cannot be repaired by Seller within 35 days after receipt of notification for whatsoever reason, Buyer has the right to claim replacement of machine or to cancel the contract as to the machine concerned.” (Contract for the sale by North American enterprise of agricultural machinery to East European enterprise.)

36. Claim to agreed sums as sole remedy

Sometimes contracts which stipulated that an agreed sum was payable on a failure of performance did not contemplate both the recovery of the agreed sum and enforcement of performance:

Illustration:

(a) “Should the buyer refuse to take delivery of the goods or to effect payment, we shall be entitled to withdraw from the contract and to claim at our option either total compensation, or without any kind of official attestation the refund of 10% of the goods’ value on account of lost profit.” (Contract for sale of goods by East European enterprise to foreign enterprise.)

In the above case, if the buyer refuses to take delivery and the seller elects to claim 10% of the goods’ value, it is apparent that he cannot also claim the price.31

(b) “In the event of any breach by the Conference of Clause 3 hereof (resulting in the shipper being unable to ship a parcel of Conference cargo within a reasonable time or at all) the Conference will pay to the shipper damages suffered thereby or a sum equal to 80 per cent of the freight (excluding trans-shipment additional) payable to one or more Members of the Conference in respect of such parcel or which would have been payable to them if such parcel had been shipped in one or more of their vessels whichever is the less and the shipper shall have the right immediately to cancel the agreement.” (Agreement between a liner conference and a shipper.)

37. Existing rules

The existing uniform rules, and laws intended to regulate international trade contracts, appear at first sight to adopt different principles on the issue under consideration, matching the differences of view reflected in draft Rule 3 and the variant to it (see paras. 28-29 above). The following appear to give the promisee the right to enforce cumulatively the main and the accessory obligations:

(a) “The payment of the conventional fine does not exonerate the debtor from performance of the obligation secured by the fine.” (Section 192, Czecho Slovak International Trade Code.)

(b) “A penalty can be claimed in addition to the performance of an obligation.” (Section 304 (1), International Commercial Contracts Act of the German Democratic Republic.)32

---

31 For a provision of the same nature, see CMEA General Conditions of Delivery, 1968-1975, article 86.

32 The Commentary to the Act notes that parties may agree that only performance, or only the penalty, is recoverable. (Kommentar zum Gesetz über internationale Wirtschaftsverträge—GIW—vom 5. Februar 1976, Berlin, 1978, p. 424.)
38. A different stand appears to be adopted in the following:

(c) "The creditor may not lay claim to cumulative enforcement of the penalty clause and of the obligation to which it applies." (Article 2 (1) of the common provisions annexed to the Benelux Convention relating to the penal clause.)

(d) "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 2 of the appendix to Resolution (78) 3 adopted by the Committee of Ministers of the Council of Europe.)

39. Possible reconciliation

Contract practice clearly suggests that a possible approach to reconciling these apparently different positions may be found on the basis of the function contemplated by the parties as being served by the agreed sum i.e. either as a substitute for performance (no cumulative enforcement of penalty and performance), or as stimulation of proper performance and compensation for loss occurring between the time proper performance is due and it is actually rendered (cumulative enforcement permissible).

D. THE RELATIONSHIP BETWEEN THE RIGHT TO OBTAIN PERFORMANCE OF THE ACCESSORY OBLIGATION AND DAMAGES FOR BREACH OF THE CONTRACTUAL OBLIGATION TO WHICH IT IS ACCESSORY

40. Draft Rule 5

Variant A

"(1) Unless the parties have agreed otherwise, the promisee is not entitled to claim damages but can only enforce the agreement.

"(2) Nevertheless, the promisee is not entitled to a sum of money in excess of the sum stipulated in the agreement or in excess of the amount of damages which he could have claimed if no such sum had been stipulated, whichever is the larger."

Variant B

"(1) In case of non-performance of the principal obligation the promisee is entitled to obtain the sum of money or to request the performance of the act as stipulated in the penalty clause. The parties may agree that such sum of money or such act constitute a minimum and that the promisee may claim full compensation. In such a case the promisee must prove his actual loss before the competent court.

"(2) The parties may agree that the sum of money stipulated by the agreement constitutes a maximum amount and that the promisor may obtain a reduction of the sum stipulated to an amount of damages actually suffered by the promisee. In such a case the promisor must prove his claim before the competent court."

Variant C

"Unless the parties have agreed otherwise, the promisee, in addition to the sum stipulated, can obtain damages in respect of the failure to perform the contractual obligation to the extent that damages exceed the amount of the sum stipulated.""

41. Divergent views were expressed on this issue in the Working Group, and these are reflected in the above variants.33

42. Exclusive recovery of agreed sum

Many examples were found of this principle (variant A (1)), particularly in regard to agreed sums payable for delay in performance.

Illustration:

"The payment of liquidated damages of up to 10 per cent of the Contract value will represent the limit of the Contractor's liability" (for delay in supplying equipment). (Contract for supply of equipment by foreign firm to South-East Asian firm).34

43. Recovery of agreed sum and recovery of damages as alternative remedies

Examples of this principle were not frequent. Some illustrations are given at paragraph 36 above.

44. Recovery of agreed sum and damages to the extent loss exceeds such sum

A few examples of this principle (variant B, paragraph (1) and variant C) were found:

Illustration:

"In case of a delay in delivery a penalty of ½ % per day will be established, which does not affect, how-

34 See also: (d) Section 193 of the Czechoslovak International Trade Code: "If a conventional fine has been agreed on or otherwise provided for, the creditor shall have no right to damages for loss suffered as result of the breach of the obligation secured by the conventional fine."
(b) Chapter 13, §4, 13-4.1, of the General Conditions of Delivery of Goods from the Member Countries of the Council of Mutual Economic Assistance to the Republic of Finland and from the Republic of Finland to the Member Countries of the Council for Mutual Economic Assistance, 1980: "If the contract provides for liquidated damages in case of delay in delivery and does not provide otherwise, the buyer shall not be entitled to claim other indemnification of damages caused by the seller's delay in delivery, than the liquidated damages."
(c) Article 2 (2) of the common provisions annexed to the Benelux Convention relating to the penal clause, done at The Hague on 26 November 1973: "That which is due pursuant to the penalty clause shall be substituted for damages due under the law."
ever, Seller's liability to re-imburse the actual damages (damages arisen from the hedge buying effected by Buyers, etc.) beyond the amount of the penalty." (Contract of sale between East European enterprise and foreign enterprise.)

45. No example was found of a contract providing that in addition to the agreed sum, damages covering the full loss suffered was recoverable. Nor was an example found of a contract providing that the promisor might prove that the extent of the actual loss was less than the agreed sum, and pay only compensation for the actual loss. (Variant B (2)).

Conclusions

46. Contract practice appears to support the principles contained in variant A (1) and variant B (1). It may be noted that there is no substantial difference in the principles contained in these variants.

E. Limitations on the Freedom of the Parties to Stipulate a Sum of Money by Way of Penalty, and the Power of Courts and Arbitral Tribunals to Modify the Amount of the Sum Stipulated

47. Draft Rule 6

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 damage likely to be suffered by the promisee."

Variant C

A provision to the effect that a court should not have the power 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-fulfilment of the obligation, is deemed not to have been written."

48. Divergent views were expressed in the Working Group on this issue, and these are reflected in the above variants. A few examples were found where the parties had indicated their wishes as regards this issue. However, their wishes would be subject to a mandatory rule of law.

Illustrations:

(a) "The rates of agreed and liquidated damages shall not be increased or decreased by arbitration." (Contract for export of non-agricultural products between North American enterprise and enterprise from Eastern Europe.)

(b) "The contractor is obliged to pay a penalty to the buyer that cannot be reduced by any legal procedure." (Contract between East European enterprise and foreign enterprise.)

49. Provisions dealing with the reduction of penalties (see variant B) were found in some laws and uniform rules:

(a) "Where the penalty agreed is disproportionately high in relation to the loss which has occurred, the obligor is entitled to demand that it be reduced to a reasonable sum." (Section 304 (5) of the International Commercial Contracts Act of the German Democratic Republic.)

(b) "A disproportionately high conventional fine may be reduced by a court to the amount of the damage actually caused with a view to the value and

35 See also Section 304 (2) of the International Commercial Contracts Act of the German Democratic Republic; "Where in any contract a penalty has been agreed, it must be applied towards the damages."

The Commentary explains that, in the absence of agreement to the contrary, the promisee is free to prove that the amount of his loss exceeds the penalty, and recover such excess. (See Kommentar zum Geset.zuber internationale Wirtschaftsverträge—GIW—vom 5. Februar 1976, Berlin, 1978, pp. 424 et seq.)

36 However, article 75 of the CMEA General Conditions of Delivery provides, inter alia, that, where defective goods are delivered, the buyer may ask for a reduction of the price (art. 75 (2)). The article also provides that the buyer is entitled to a penalty for the loss suffered between the date of his claim and the date of agreement to reduce the price (art. 75 (5)). The parties can agree that the amount of the price reduction includes the amount of the penalty payable. Paragraph 6 provides as follows:

"The parties have agreed on the amount of the rebate but have not reached an agreement on whether the penalty provided for in paragraph 4 of this article should be included in the amount of the rebate or whether it should be added thereto, then in cases where the actual losses incurred by the buyer because of not having utilized the merchandise up to the time an agreement is reached on the rebate were less than the amount of the penalty, the penalty charged or paid shall be reduced to the amount of the actual losses; and, in the cases where the losses were greater than the penalty, the amount by which the actual losses exceed the penalty shall be paid to the buyer by the seller if so provided in a bilateral agreement." (Emphasis added.)

A similar provision is found in article 31, when a claim is made for a defect covered by a guarantee during the guarantee period, and the remedies of a price reduction together with a penalty are adopted by the parties (see art. 31 (7)).


38 The Commentary notes that the reduction need not be to the exact extent of the loss, but to a sum which might be a little higher. (Kommentar zum Geset.zuber internationale Wirtschaftsverträge—GIW—vom 5. Februar 1976, Berlin, 1978, p. 425.)
the importance of the obligation.” (Section 194 of the Czechoslovak International Trade Code.)

(c) “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 7 of Resolution (78) 3 on penal clauses in Civil Law adopted by the Committee of Ministers of the Council of Europe.)

Conclusions

50. Both the view that the agreed sum should not be reduced, and that the sum should be reduced if excessive, have support. Although the three provisions cited providing for reduction (paragraph 49 above) adopt different formulations, it would appear that their main object is to provide for a reduction which would make the sum mainly compensatory, although the reduced sum may to a minor extent exceed the compensatory damages which a national legal system might award.

Part II. The particular types of international trade contracts which might usefully be regulated by uniform rules

Definition of an International Contract

51. The Working Group was agreed that the proposed Rules should apply only to international trade contracts. A definition appropriate in the context of the proposed Rules is needed of the criteria to be satisfied to make a trade contract qualify as international. Varying criteria (different nationalities of the parties to the contract, connection of the transaction with different legal systems, the subject matter of the contract) have been adopted for this purpose by legal systems and uniform rules. While a decision on this question may be premature at the present stage, it may be noted that the criterion adopted in the United Nations Convention on Contracts for the International Sale of Goods (the parties having their places of business in different States) is simple, and could apply to the variety of contracts to which the proposed Rules might apply.

52. During the examination of contract clauses undertaken for the purposes of this study, it was noted that liquidated damages and penalty clauses were regularly used in several traditional types of international contracts (e.g. sales, transport, construction, agency and distributorship). However, such clauses were also used in contracts of more recent origin relating to economic development (e.g. international contracts for the licensing of technology, and international contracts between parties associated for the purpose of executing a specific project). An analysis of these clauses indicated, that their use was associated, not with the contract being of a certain type, but with the probable presence of some of the following features:

(i) Breach of the main obligation was relatively easy to prove (e.g. failure to deliver on time, failure to meet a technical specification);
(ii) The existence of some basis at the time of conclusion of the contract for estimating the loss likely to be caused from a breach. In regard to some types of contracts, norms appeared to have developed in the trade defining the limits of the agreed sums which parties might stipulate;
(iii) Proof of actual loss might be costly or difficult;
(iv) Breach of the main obligation is not of so serious a character as to justify, at least initially, the ending of the relationship between the parties;
(v) A need to limit the liability exposure of the party liable for breach of the main obligation;
(vi) Circumstances which make it important to a party that he receive performance, and not damages for breach.

53. Almost any type of contract can contain an obligation in relation to which some of the above features are present, making the insertion of a liquidated damages or penalty clause appropriate. Certain types of contract almost always contain an obligation in regard to which such features are present (e.g. the obligation in a construction contract to complete by a specified date.)

43 Guidelines for the acquisition of foreign technology in developing countries (UNIDO publication, ID/98), p. 23, and Guide for use in drawing up contracts relating to the international transfer of know-how in the engineering industry (ECE publication TRADE/222/Rev.1), paras. 75.
44 Guide for drawing up international contracts between parties associated for the purpose of executing a specific project (ECE publication ECE/TRADE 131), para. 30.
45 Thus in relation to international construction contracts it has been stated, “The rate of deduction for late performance varies with the size, complexity and importance of the project. As a general guide, the rate is frequently between .0001-.001 per cent of the contract price per day. An upper limit is not generally specified, but if one is desired 5-10% would be reasonable.” Guidelines for contracting for industrial projects in developing countries (UNIDO publication ID/149 and Corr.1), p. 22.
other types of contract, such obligations may be less frequent. Thus, in the research contract, where one party engages the other to conduct research with a view to obtaining certain results, the duties of the research worker are often defined in a flexible manner. The objective of the research might change as the research progresses. The party commissioning the research relies for proper performance on the integrity and professional status of the research worker. In view of these circumstances liquidated damages and penalty clauses are less often found in such contracts.

54. The considerations set forth above suggest that it might be inadvisable to exclude any types of contract from the application of the proposed Rules. Such an attempt would also be inadvisable because of the varieties of contractual obligations, and the difficulty of fitting certain combinations of obligations into named types. However, it is possible to envisage cases where, for different reasons, application of the proposed Rules might be inappropriate.

GROUND OF PUBLIC POLICY

55. Many legal systems in certain areas (employment contracts, leasing contracts, loans) contain special provisions based on public policy which may relate to liquidated damages and penalty clauses. In some instances these provisions may not apply to international contracts either because they have a purely domestic ambit, or because the abuses they seek to restrain do not usually occur in international transactions. However, States may prefer such provisions to prevail over the proposed Rules where the former are applicable to international contracts.

EXISTING CODIFICATIONS

56. The legal rules regulating certain areas of international trade may be codified in the form of treaties or laws at a global or regional level. Where these codifications also regulate the use of liquidated damages or penalty clauses, the view may be taken that it is preferable for these rules to prevail over the proposed Rules. Where the codification takes the form of model contracts which are in general use, much will depend on the particular contracts. If, for instance, the contracts are clearly drafted, respond to the needs of the particular trade, and through regular use have created settled expectations among parties, it may be more convenient not to apply the proposed Rules.

AREAS OF LAW WITH A DISTINCTIVE CHARACTER

57. Instances may be found where, in a certain area of international trade, a liquidated damages or penalty clause is used with a special meaning or function. This will be due to special considerations relevant to that area. It may be difficult to accommodate the special features of such use in uniform Rules suited to a wide range of contracts.

58. Whether there is a need to incorporate in the Rules a limitation as to the types of contracts to be regulated by the Rules might depend on the circumstances in which the Rules are to become applicable. Thus if the Rules were to be applicable upon a choice by the parties, it could be left to the parties not to apply the Rules to contracts to which they were unsuited.

Part III. The legal difficulties encountered in the use of liquidated damages and penalty clauses, as shown by court and arbitral decisions

59. The Secretariat encountered difficulties in obtaining a representative sampling of court and arbitral decisions on liquidated damages and penalty clauses in international contracts. Arbitral awards are generally regarded as confidential, and are not reported. In regard to court decisions, there was difficulty of access to decisions of many countries. Furthermore, even in jurisdictions where indexes of decisions on liquidated damages and penalty clauses were available, these indexes did not single out the decisions on clauses contained in inter-

---

46 The rules of some professional bodies prevent the members of these bodies from inserting guarantees for performance in contracts entered into by them. “A member will decline to give a bond for the faithful performance of engineering services, unless required by foreign practice.” Rule 21 of the Standards of Professional Conduct, American Institute of Consulting Engineers, set forth in Manual on the use of consultants in developing countries (UNIDO publication ID/3/Rev. 1), annex 4. However, penalties are sometimes inserted. Draft guide for drawing up international contracts on consulting engineering, including related aspects of technical assistance (ECE document TRADE/GE.1/R.22/Rev.1, paras. 75-77).


48 See also A/CN.9/161, para. 14 (Yearbook . . . 1979, part two, I, C).
national contracts. It is possible that a more prolonged search would reveal further relevant decisions.50

PROBLEMS ARISING FROM THE CONTRACT'S INTERNATIONAL CHARACTER

60. As was to be expected, decisions were found where courts had to consider the effect of foreign law on a liquidated damages or penalty clause.51 The extent of the difficulty of determining which was the applicable law, and ascertaining the contents of the law, would depend on the circumstances of the case.

61. Cases also were found where courts had applied the provisions of their own law permitting them to reduce penalties, on the basis that it would be contrary to public policy to enforce the penalty in its agreed amount.52

62. In regard to the enforcement of a foreign judgement, it was decided that the misapplication of English law by a foreign court, resulting in the enforcement of a penalty instead of its invalidation, did not prevent the judgement from being enforced in an English court.53

INTERPRETATION OF CONTRACT

63. In several decisions, the issue involved was the interpretation of the contract in question. The majority of such cases did not present any features of interest to the present study. The following decisions may, however, be noted:

(1) It has been observed that liquidated damages and penalty clauses are very frequently inserted in respect of delay in performance.54 However, when the breach consists not in delay but non-performance, the penalty is nonetheless recoverable, as non-performance could be interpreted as indefinite delay.55

(2) Where the contractual provisions relating to remedies for breach in a contract in writing did not include a penalty clause, but it was usual in the trade in question to award compensation for loss caused by a certain type of breach by awarding a penalty at a specified rate, compensation should take the form of a penalty at that rate.56

(3) To qualify as a penalty clause, it must provide that the agreed sum is payable on breach of contract. A clause which stipulates that a buyer who requests extension of the shipment period in a C.I.F. contract may be granted the extension by the seller, provided the buyer pays the seller a sum of money as the price of the extension, is not a penalty clause.57

INTERPRETATION OF THE LAW

64. Many decisions dealt with the interpretation of the law, or the application of the law to the facts. Most of these decisions dealt with issues irrelevant to the present study.58 The following dealt with some of the relevant issues noted above.

ACCESSORY NATURE OF THE PENALTY

65. If the main obligation is not valid, the promisor is under no duty to pay under the accessory obligation.59

50 The Secretariat referred, inter alia, to the following material containing awards: Yearbook Commercial Arbitration, vols. 1 (1976)-IV (1979) (Kluwer B.V., The Netherlands); Zarsczenictwa Kolegium Arbitrów przy Polskiej Izbie Handlu Zagranicznego (Wydawnictwo Prawnicze, Warszawa, 1980); Aus der Sprachpraxis des Schiedsgerichts bei der Kammer für Aussenhandel der Deutschen Demokratischen Republik, 1954-1968 and 1969-1976 (Kammer für Aussenhandel der Deutschen Demokratischen Republik); Digest of Court Decisions of the American Arbitration Association, vols. 1-IV, no. 1 (March 1980); Quarterly of the Japan Commercial Arbitration Association, vol. 1 (1978)-no. 31 (Oct.-Dec. 1978); Decisions of the Moscow Foreign Trade Arbitration Commission, part 1 (1934-1951)-part VII (1971-1974); and surveys of arbitral awards in recent issues of the Journal du droit international (Editions Techniques S.A., Paris) and the Revue d'Arbitrage (Librairies Techniques, Paris). As regards case law, apart from reference to available textbooks and indexes, a search of British cases after 1945 was made in the LEXIS computer library through the courtesy of Messrs. Butterworths (Telepublishing) Ltd., London. As regards the case law of the United States in the LEXIS library, a preliminary search was made through the kind assistance of Professor E. Allan Farnsworth of the Law School of Columbia University, New York. A search was also made in the EUROLEX computer library through the courtesy of the European Law Centre Ltd., London. The Secretariat is most grateful for the help provided by these searches. A commentator has recently noted that, from the reported cases, penal clauses do not appear to be a subject of frequent litigation: Georges R. Delaume, Transnational Contracts, vol. 1, Oceana Publications Inc. (1980), § 3.04.


53 Godard v. Gray, (1870) Law Reports, VI Queens Bench, 139.

54 See para. 33 above.


56 Yves Derains, "Cours d'arbitrage de la Chambre de Commerce Internationale: chronique des sentences arbitrales", Journal du droit international, vol. 102, no. 4 (1975), p. 916, at 929 (sentence rendue dans l'affaire No. 2139 en 1974). For a similar approach to awarding compensation, see also Case No. 25, From the practice of the Maritime Arbitration Commission (1969-1972) (Moscow, 1972), p. 92. In draft Rule 1 at paragraph 10 above, the issue whether the proposed Rules should only apply to clauses in writing is left open.


58 E.g., decisions as to whether under the common law a particular clause should be qualified as a liquidated damages clause or penalty clause: Clydebank Engineering and Shipbuilding Co. v. Don Jose Ramos Yeguiero Y Castenada, (1905) Appeal Cases 6; Hellenic Lines Ltd. v. Embassy of Pakistan, 467 Federal Reporter, 2nd Series 1150.

66. Under a standard form of charter-party, penalties were payable by the charterer to the shipowner if there was delay in loading the ship. It was held that, by uniform international practice, the contract was interpreted as making the penalties payable even if the delay in loading resulted from "force majeure." By using the standard form, parties had implicitly agreed to this interpretation.60

67. The payment of penalties due for delay in delivery of a machine does not prevent the buyer from obtaining an order for the delivery of the machine.61

THE RIGHT TO OBTAIN BOTH PERFORMANCE OF THE MAIN OBLIGATION AND PAYMENT OF THE PENALTY OR LIQUIDATED DAMAGES

68. Some decisions were found supporting the view that both the penalty and damages together were not recoverable.62 However, it has also been decided that where a seller knew that the goods he was selling were intended to form part of a machine which the buyer was selling to a third party, and delay in delivery of the goods in turn caused a delay in the delivery of the machine, the seller was liable both for penalties stipulated for delay, and for the damages payable by the buyer to the third party.63

REDUCTION OF THE AGREED AMOUNT

69. The fact that no damage was suffered by the promisee, or less damage than the value of the penalty, was not a ground for denying recovery of the penalty, or reducing it, because the agreed amount had the character of a standardized indemnity.64

70. The following factors were recognized as justifying a reduction of penalties:

(a) The amount of the penalty being excessive in relation to the value of the goods, and the measure of the fault of the promisor; or

(b) The promisee contributing equally to the breach of contract.65

(c) The excessive nature of the penalty in relation to the loss suffered; or

(d) Action by the promisee in contravention of established practice contributing to his loss.66

Part IV. Revised set of draft Rules

71. The revised draft Rules, with comments, set forth below are submitted with a view to assisting the Working Group in its deliberations. The scope of these revised draft Rules is confined to the issues raised at the first session of the Working Group. They are arranged in the same order that the preliminary draft Rules were presented to the first session of the Working Group. They may need to be expanded to cover other issues which the Working Group may wish to consider (e.g. allocation of the burden of proof, consequences of rescission or cancellation of the contract by a party).67

SCOPE OF APPLICATION

72. Revised draft Rule I

"These Rules apply to a contract in which the parties have agreed [in writing] that, upon a total or partial failure of performance by a party (the debtor), another party (the creditor) is entitled to recover, or to forfeit, an agreed sum of money."

Comments:

73. An attempt has been made to reflect decisions taken by the Working Group at its first session.68 Accordingly, no reference is made to the object of the agreement (penalty, compensation, limitation), or to the possibility of the performance of an act by the debtor.

74. The focus has been shifted from the duty of the debtor to pay (as in the earlier draft) to the right of the

61 Award in the case of the complete plant and equipment Foreign Trade Organization COMPLEX of Hungary, against V/O Tjahpromexport, No. 109, Collected Arbitration Cases, Part IV, The USSR Chamber of Commerce and Industry, Law Section (Moscow). The issue was decided by reference to S. 36 of the Fundamentals of Civil Law of the USSR and of the Soviet Constituent Republics.
62 Award of 6 March 1941, in the case of the claim of V/O Razoimport against the Bulgarian Joint-Stock Company Musulva and Trading House Srdika, No. 18, ibid., part I. The issue was decided by reference to article 141, note 1, of the R.S.F.S.R. Civil Code; award of 12 March 1941 in the case of the claim of V/O Vostokintorg against the Turkish firm Sümerbank (Izmir), no. 19, ibid.; award of 18 February 1966 in the case of Maschinen-Export (Berlin) against V/O Maschinenexport, no. 152, ibid., part V. The issue was decided by reference to the Protocol of 11 April 1958 between the USSR and the German Democratic Republic; Istvan Szasz, "Chronique de jurisprudence hongroise de droit international privé (1945-1972)", Journal du droit international, vol. 100, no. 2 (1973), p. 467, at 497. The issue was decided by reference to the provision of the CMEA General Conditions of Delivery, 1958.
66 The award of 7 May 1956, in the case of the Deutscher Innen-und-Aussenhandel Chemiek (Berlin) against V/O Sokuzbinskexport, No. 52, Collected Arbitration Cases, Part II, The USSR Chamber of Commerce and Industry, Law Section (Moscow). Reference was made to article 142 of the Civil Code of the R.S.F.S.R.
creditor to recover, in order to cover the case where the creditor recovers under a performance bond. (See para. 17 above.)

75. The following matters need consideration:

(1) Definition of the circumstances which would make a contract qualify as international;

(2) Whether any types of contract are to be excluded from the scope of Rules, and if so, how this should be done; and

(3) Whether the requirement of a written agreement is to be maintained or not.

Regulation of the Contract by the Rules

76. Revised draft Rule 2

"Unless the parties have agreed otherwise, the creditor is not entitled to recovery or forfeiture of the agreed sum if the debtor is not liable for the failure of performance."

Comments:

77. The Working Group was in general agreement upon the substance of this Rule. It operates when there is a defence to an action for the failure, or where the right of the creditor arising from the failure is extinguished (e.g. by expiry of the prescription period). The allocation of the burden of proof may need clarification.

78. Revised draft Rule 3

"(1) When the agreed sum is intended by the parties to be complete compensation for the loss caused by a failure of performance, the creditor cannot enforce performance if he enforces recovery, or forfeiture, of the agreed sum.

"(2) When the agreed sum is intended by the parties to compensate the creditor for the loss caused in the period between a failure of performance and the time when proper performance is rendered, the creditor may enforce performance, and also enforce recovery, or forfeiture, of the agreed sum.

"(3) Parties may by agreement provide otherwise."

Comments:

79. This Rule, and draft Rule 5 below, address two connected issues: regulating the combination of possible remedies, and the prevention of unfairness.

80. The Working Group was not agreed on the proper principles to regulate this issue. To have a rule under which in all circumstances the creditor only recovered the agreed sum would result in his under-compensation in some cases. To have a rule under which the creditor in all circumstances recovered the agreed sum, and could also

enforce performance of the obligation in breach resulted in his over-compensation in some cases. An attempt is made in sub-rules (1) and (2) above to deal with two cases occurring often in practice, and to set forth acceptable results for these cases. Under (3) above, parties are free to change these results, and to make provision for other situations.

81. It may be noted that regulating the possible combination of remedies is only one factor in preventing unfair compensation. The amount of the sum agreed as a penalty or liquidated damages is also relevant. Thus, upon an application of sub-rule (1) above, if the sum is fixed at an amount exceeding the value of the loss caused by the breach, the creditor will be over-compensated. Variation of the specified sum under draft Rule 6 may be regarded as an effective remedy to unfair compensation.

82. Revised draft Rule 5

"If a failure of performance in respect of which parties have agreed that a sum of money is to be recoverable, or forfeited, occurs, the creditor is only entitled to recover, or forfeit, the sum, and is not entitled to damages. Parties may agree that the creditor, if he proves that his loss exceeds the amount of such sum, may also recover the amount of the excess."

Comments:

83. As regards the issue regulated by this Rule the principles contained in the above draft Rule were reflected most often in the contracts examined.

84. Revised draft Rule 6

Variant 1

"The agreed sum shall neither be increased nor reduced."

Variant 2

"The agreed sum specified may be reduced when it is manifestly grossly excessive in relation to the loss which has occurred, but only if such sum did not constitute a genuine pre-estimate by the parties of the loss likely to be suffered by the creditor."

Variant 3

"An agreement of the kind described in Rule 1 above shall be void if the agreed sum is manifestly grossly excessive in relationship to both (a) the loss that could reasonably have been anticipated from the failure of performance, and (b) the actual loss caused thereby. The agreement shall not be void if the loss could not have been precisely predicted or cannot be precisely established."

---

68 A/CN.9/177, paras. 20-21 (Yearbook... 1980, part two, II).
69 A/CN.9/177, paras. 22-28 (Yearbook... 1980, part two, II).
70 See para. 29 above.
72 For the variants considered by the Working Group, see A/CN.9/177, para. 29-36 (Yearbook... 1980, part two, II).
Comments:

85. The above formulations are based on variants submitted to the Working Group. Variant 1 provides

that the specified sum shall not be reduced, variant 2 provides that it may be reduced in certain circumstances, and variant 3 provides that it may be void in certain circumstances. Further work must depend on a decision as to which approach is to be adopted.

2. REPORT OF THE SECRETARY-GENERAL: ANALYSIS OF EXPERT OPINIONS, AND OF REPLIES TO THE SECRETARIAT QUESTIONNAIRE ON LIQUIDATED DAMAGES AND PENALTY CLAUSES (A/CN.9/WG.2/WP.33/ADD.1)*

CONTENTS

INTRODUCTION
ANALYSIS OF OPINIONS AND REPLIES
Question 1
Question 2
Question 3
Question 4
Question 5
Question 6
Question 7
Question 8

Paragraphs
1-2
3-20
3-4
5-6
7-8
9-10
11-12
13-15
16-18
19-20

ANALYSIS OF EXPERT OPINIONS, AND OF REPLIES TO THE SECRETARIAT QUESTIONNAIRE

Introduction

1. In order to obtain views on commercial practice in regard to liquidated damages and penalty clauses, and in particular as to their experience in difficulties encountered in the negotiation, drafting and enforcement of such clauses, the Secretariat solicited the opinions of selected legal experts. The Secretariat also requested the International Chamber of Commerce (ICC) to circulate a questionnaire on the subject to its national committees.1

2. Replies to the questionnaire were received from Belgium, France, Finland, Germany, Federal Republic of, India, Israel, Italy, Japan, Norway, Republic of Korea, Sweden and Turkey. The questions contained in the questionnaire are set forth below, and under each question is set forth an analysis of the replies received to that question. A few opinions were received from legal experts, and it appeared convenient to record these opinions in the present document. The opinions are contained in footnotes under each question in the questionnaire to which the opinion expressed was relevant.

1 The Secretariat is most grateful to the International Chamber of Commerce for its co-operation, and to the ICC Secretariat for its assistance.

Analysis of opinions and replies

Question 1:

3. 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?

4. The majority of respondents noted that such provisions were inserted often in international contracts, while some noted that they were inserted occasionally. Some respondents observed that the likelihood of the insertion of such provisions depended on the type of contract in question, such provisions being normally inserted in contracts for the supply of goods, for failure to observe the stipulated delivery time, and in contracts for the supply and erection of plant and machinery.²

Question 2:

5. Have you encountered difficulties in agreeing upon the insertion of such provisions in international contracts? Please give details.

6. The majority of respondents noted that, while there was often agreement on the need for such provisions, difficulties were encountered in agreeing on their contents (especially on the amount of the sum payable,

² See also the replies to question 4 below.