Agreed Payment for Non-performance in International Commercial Contracts

Mila Marissa Hälinen

Master's Thesis in European and International Trade Law

HARN63

2021

Supervisor: Prof. Niklas Arvidsson

LUND UNIVERSITY

SCHOOL OF ECONOMICS AND MANAGEMENT

Table of Contents

Abstract

The commercial contracts commonly require an agreed payment clause for non-performance. This clause provides agreed statement of the amount recovered by the innocent party in case of a breach of contract. The term, agreed payment for non-performance includes two types of clauses, penalty clause and liquidated damages clause. The penalty clause and liquidated damages clause have similar features but are treated very differently in certain jurisdictions. The international law does not specifically state anything regarding this topic but the model rules are presented and compared in this thesis. The background law of the contract defines how the liquidated damages clause and penalty clause are treated and validated. The benefits and the validity of the agreed payment for non-performance clauses are analysed in this thesis by using Finnish law and English law as an approach.

Abbreviations

CISG	International Sale of Goods
CESL	Common European Sales Law
DCFR	Draft Common Frame of Reference
EU	European Union
PECL	Principles of European Contract Law
PICC	Principles of International Commercial Contract
UNCITRAL	Uniform Rules on Contract Clauses for an Agreed Sum Due upon Failure of Performance’

1. Introduction

1.1 Background

Commercial contracts often include clauses defining an agreed sum which the party failing to perform their obligated part has to pay for the innocent party. These clauses are called 'Agreed Payment for Non-performance'. The reason to use this mentioned term is to avoid the usage of the two separate terms, liquidated damages clause and penalty clause, which often occur in national jurisdictions and legal publications.

By definition, the liquidated damages clause refers to pre-agreed sum which the breaching party will be expected to pay for the innocent party in case of a non-performance or damages.[1] Instead, the aim of the penalty clause is to prevent the contracting parties from preaching the contracting terms. The amount of penalty in a contract is often greater than the actual loss of the innocent party.[2]

The general term, agreed payment for non-performance, refers to both liquidated damages clauses and penalty clauses.[3] The most common reasons for their usage is to calculate the possible damages by a specified breach of contract, the actions and penalties following from a non-performance, and the absolute limit of damages which the clauses cover in that specific contract. The estimation of damages should be calculated in good faith as the contracts, in general, are to be made in common understanding and agreement to perform them accordingly. The agreed sum should not exceed reasonably calculated damages. The optimal agreed payment clause is high enough to provide pressure to the performing party but not too high to intimidate them off the contracting relationship.[4]

There are no binding international rules regarding the usage and difference of agreed payment clauses but there are model rules which govern this area of law.

---

[1] Roger Halson, *Liquidated Damages and Penalty Clauses* ,(Oxford University Press, 2018). pp.123-127

[2] Reinhard Zimmermann, 'Art 9:509: Agreed Payment for Non-Performance'. pp.1539-1540

[3] Roger Halson, *Liquidated Damages and Penalty Clauses* ,(Oxford University Press, 2018) . pp.123-127

[4] Reinhard Zimmermann, 'Art 9:509: Agreed Payment for Non-Performance'. pp.1539-1540

However, the validity of penalty clause varies between the national legal systems.[5] In this thesis, the national law which the contract is ruled by, is referred to as the background law.

The penalty clause has long traditions in English law. Even in those national jurisdictions which allow the penalty clause to be used, the amount of the penalty is often diminished by the court in order to present a more reasonable sum. In practice, the validity and significance depends on the jurisdiction governing the contract.[6]

1.2 Aim and research question

The purpose of this thesis is to present how the liquidated damages clause and penalty clause are treated according to the background law. The use of agreed payment clauses are presented and analyzed by using examples of English law and Finnish law as the background laws in order to better present the differences of these two approaches. The general reason behind the decision to compare these two legal systems, is the fact that Finland and other Nordic countries generally enforce the penalty clauses and treat them as any other clause of the contract. Instead, the English law did not enforce the penalty clause before the Cavendish case, which is later presented into detail in this thesis. Even after the Cavendish case there are conditions for the enforcement regarding the primary and secondary rule.[7] The decision to choose Finnish law instead of any other Nordic law was based on my personal experience in Finnish contract law in the commercial segment.

It is clear that for specific type of contracts the penalty clause can be beneficial in order to protect the innocent party. This type of contracts are for example the loan agreements and construction contracts. The benefits and dis-benefits are presented and analyzed in this thesis by using case examples and related laws. When the penalty rule presents a justifiable role in the contract, is agreed priorly between the

[5] Ibid.,1540

[6] Peter Benjamin, 'Penalties, Liquidated Damages and Penal Clauses in Commercial Contracts: A Comparative Study of English and Continental Law' (1960) 9 Int'l & Comp LQ 600

[7] Cavendish Square Holdings BV v Makdessi; ParkingEye Ltd v Beavis [2015] UKSC 67

contracting parties and is valid according to the background law of the contract, the benefits of it can be significant.[8]

The research question of this thesis is, what makes the penalty clause and liquidated damages clause enforceable. In order to answer this question, the difference between liquidated damages clause and penalty clause needs to be distinguished. Not in all jurisdictions the difference is necessary to be made but for the national laws which do not generally consider penalty clause valid, the difference must be clarified. The common law and civil law jurisdictions treat the penalty clause differently. For the mentioned reason, this thesis describes the different treatments and interpretations in Finnish and English law.

This thesis focuses on the reasons, validity and benefits of using agreed payment for non-performance clauses in commercial contracts. General theories of their use is presented and justified by cases and studies fitting to the matter. In addition to that, this thesis analyzes the improvements and benefits of the penalty clause in the jurisdictions allowing the use of it.

1.3 Scope and constraints

The research contains both historical background from the Roman times when the penalty clause was first implemented into the contract law but focuses on the interpretation of the clause today. In addition to that, the chapter presenting adjustments which would develop the process into more efficient model presents some suggestions for bettering the future contract law system.

The scope of this research has been knowingly limited to Finnish law and English law in order to comprehensively present all the possible facts regarding this matter. These two jurisdictions have been chosen for comparison and to promote discussion due to their significant differences regarding the validation of the penalty clauses. Regarding the English law, the reformation of the penalty ruling after the Cavendish case has been highlighted in this thesis.[9]

---

[8] Roger Halson, *Liquidated Damages and Penalty Clauses* ,(Oxford University Press, 2018) . pp.120-131

[9] Cavendish Square Holdings BV v Makdessi; ParkingEye Ltd v Beavis [2015] UKSC 67

This research can be beneficial for a reader not familiar with drafting a contract and agreed payment clauses for the protection of their business or customer ship. This thesis offers a general knowledge about the differences of the penalty clause and liquidated damages clause, and how to incorporate those into the contract in the most beneficial matter.

One could further research which approach, Finnish or English, of the enforcement of penalty clause is more beneficial on a larger scale. This research could be executed by analyzing the dispute time and cost of damages on a certain timeline in both chosen jurisdictions presented in this thesis.

1.4 Materials and method

This thesis topic has been researched from legal literature, articles and papers, commercial contracts and law of the scoped countries. One of the main literature sources is the book, 'Liquidated damages and Penalty Clauses' by Roger Halson. This source offers information on a general and comparing level. Halson presents the enforcement and comparison in both civil law and common law countries. The arguments of the research have been defended by applicable cases which elaborate both the problematic features and beneficial solutions of the agreed payment for non-performance clauses.[10]

An article written by Ugo Mattei, 'The Comparative Law and Economics of Penalty Clause in Contracts', explains the useful benefits of a penalty clause in construction contracts. Mattei´s article has been used as one of the main resources in this thesis to further more support the use of penalty clause but in addition to that to analyze the disbenefits of using the penalty clauses. This article is based on the common law enforcement of the penalty clause but offers comparison to the civil law procedure. [11]

In this thesis, it was important to define the difference between the liquidated damages and penalty clause regarding those jurisdictions which do not enforce penalty clauses and the difference between these two clauses matter. In order to

[10] Roger Halson, *Liquidated Damages and Penalty Clauses* ,(Oxford University Press, 2018). pp.200-212

[11] Ugo Mattei, 'The Comparative Law and Economics of Penalty Clauses in Contracts' (1995) 43 Am J Comp L 427

define the difference between these two clauses, I used a book 'Liquidated Damages and Penalty Clauses' by Roger Halson as an reference to discuss this topic.[12] In addition to that, Dunlop Pneumatic Tyre v New Garage (1915) AC 79 case further illustrated the five step test to clarify difference between these two clauses from each other. The judgment has been given by the House of Lords in England. [13]

As mentioned above, in those jurisdictions which do not enforce penalty clauses, it makes a difference whether a rule is a primary or a secondary rule in the contract. The Cavendish Square Holdings BV v Makdessi; ParkingEye Ltd v Beavis case served as an excellent resource to discuss the topic of primary and secondary rule by offering an illustration of the matter. [14] This case has been chosen to further explain the general conclusion of the non-enforcement and change in the enforcement of the penalty rule in the common law countries, such as England.

Another main resource of this thesis is an article by Reinhard Zimmermann, 'Art 9:509: Agreed Payment for Non-Performance'. Zimmermann has accomplished a well-structured article regarding how there are no international rules over the use of penalty rules but rather model rules of the usage of the clause.[15] I have used his article as a reference to define the international point of view regarding penalty clauses and how they should be viewed in international commercial contracts.

One of the main legal sources presented in this thesis is the CISG article 4 and 6. The CISG does not specifically state about the liquidated damages clause but rather allows the contracting parties to freely agree on the fixed sums in their terms. These articles present important rulings regarding freedom of contract and national law.[16] I have used these articles to further define the enforcement of penalty clauses and to present a defending argument for their usage in commercial contracts in those jurisdictions which allow penalty clauses.

I would also like to mention Peter Benjamin´s study, 'Penalties, Liquidated Damages and Penal Clauses in Commercial Contracts: A Comparative Study of English and Continental Law', which presented information of several types of

[12] Roger Halson, *Liquidated Damages and Penalty Clauses* ,(Oxford University Press, 2018) . pp.200-212

[13] Dunlop Pneumatic Tyre v New Garage (1915) AC 79

[14] Cavendish Square Holdings BV v Makdessi; ParkingEye Ltd v Beavis [2015] UKSC 67

[15] Reinhard Zimmermann, Art 9:509: Agreed Payment for Non-Performance. pp.1539-1540

[16] CISG, International Sale of Goods, Articles 4 and 6.

commercial contracts which benefit from the use of penalty clause in England. In addition to that, the study pointed out how different the relationship between contracting parties may be and affect the need of penalty clause. I have used Benjamin´s study to analyze the beneficial scenarios and non-beneficial contracting relationships to use penalty clause.[17] This publication, as well as the other ones mentioned above, have been used to carefully provide a general conclusion of the Common law view on the enforcement of the penalty clause.

To further illustrate the Finnish legal view on penalty clauses, I have used as a main reference a book by Mika Hemmo, 'Sopimusoikeus I'. Hemmo has elaborated the freedom of contract and how that principle has effected the enforcement of penalty clauses in the Finnish legal system. [18] This, and the following Finnish legal publications have been used to provide a comprehensive general conclusion of the enforcement of the penalty clause in the Civil law countries, such as Finland.

The general enforcement of penalty clauses in Finnish law has been supported by using a book 'IT-sopimukset, käytännönkäsikirja' by Pekka Takki. A discussion of contract violations and penalties in Finnish law has been supported by using this book as one of the main references. [19]

Regarding the example presented of an anonymous Finnish software company and their penalty clauses in the commercial contracts, the subject has been further supported with references from a book by Antti Hannula and Juha Virmavirta, 'Ohjelmistovienti-Sopimusjuridiikan käsikirja'. This book further explains the compexity of IT-contracts and the penalties regarding them. [20]

The method used in this research is document analysis and legal document analysis by using the above mentioned references and other relevant books, legal documents, and articles to further support the arguments of this thesis and to answer the research questions. I have compared Finnish and English national law to fulfil the purpose of this thesis, which is to analyse the enforcement of the agreed payment for non-performance clause according to the background law. The background laws are

[17] Peter Benjamin, 'Penalties, Liquidated Damages and Penal Clauses in Commercial Contracts: A Comparative Study of English and Continental Law' (1960) 9 Int'l & Comp LQ

[18] Mika Hemmo, 'Sopimusoikeus I'(1997) Gummerrus.

[19] Pekka Takki, 'IT-sopimukset, käytännönkäsikirja', 2003

[20] Antti Hannula, Juha Virmavirta, 'Ohjelmistovienti-sopimusjuridiikan käsikirja'. (1994)

Finnish law and English law in this scenario. In addition to that, international law has been studied to further investigate whether or not it offers advice regarding the enforcement of the penalty clause.

This thesis has been executed by qualitative analysis but this topic could further be analysed by counting the actual cost of breach of contract in both Finnish and English law. This thesis thrived to answer the research question on a theoretical level but to actually prove the efficiency of the process, the cost of it should be proved.

1.5 Structure

In this thesis, I begin by defining the functions of the agreed payments for non-performance. This chapter describes the benefits and how these clauses are generally used in different types of commercial contracts like loan agreements, manufacturing contracts and construction contracts.

I then move on to the chapter three which describes the difference between penalty clause and liquidated damages clause. This distinction is mandatory for those jurisdictions which generally do not consider penalty rule valid. This chapter draws the difference between the two types of clauses and in addition to that, describes the issues in those clauses. The arguments are defended by representing appropriate cases which clarify the matter by practical examples.

Chapter four considers the validity of the penalty rule. Even though, the penalty clause is commonly used in commercial contracts, is it beneficial when examined closely and considered all aspects of it. As in few other chapters, the arguments and theory are supported by case examples which further explain the matter.

The fifth chapter overviews the interpretation of the agreed payment for non-performance clauses.. This chapter is heavily supported by related cases to better present the interpretation in practice. The history of the interpretation is important to be presented in order to understand the usage of penalty rules today.

Chapter six considers adjustment and how the concept of agreed payment for non-performance and contract process could be made more reliable and efficient. In this

chapter, the efficient model from an article written by Ugo Mattei is detailed and presented[21]. The concept, freedom of contract is described into detail due to the importance and impact of it on the contract law. Freedom of contract is one of the main defences to support the usage of penalty rule. Lastly, this chapter details the process of drafting a penalty clause and around the definition of a penalty clause.

The last chapter, Damages according to background law, describes the different jurisdictions and their approach on the penalty clause. I have chosen to focus on the English law and Finnish law to compare and declare the main differences between these two approaches. The chapter seven includes description of the international model rules which give an advice regarding this matter to implement on the international level.

[21] Ugo Mattei, 'The Comparative Law and Economics of Penalty Clauses in Contracts' (1995) 43 Am J Comp L 427

2. Functions of the Agreed Payment for Non-Performance in Commercial Contracts

2.1 Introduction

The function of the agreed payments for non-performance in the commercial contracts is to provide security for the parties regarding the contractual obligations and to estimate the damages of a possible contractual breach As in any contracting relationships, good faith in entering a contract should be one of the core values. For the mentioned reason, the agreed payment clauses are not serving main function as a threat but as a reasonable proof to claim damages. When optimized the amount of the agreed payment clause, the contract becomes effective for both parties without significant risks. [22]

Different types of contracts include the agreed payment clauses. Examples where they are most useful and common are the loan agreements, construction contracts and rental agreements. In the commercial contracts, like the example software company contracts, the agreed payment clauses are related to misbehavior regarding the delivery of payment. Vise versa, the customers of this software company often include penalty clauses into their contracts proving damages from late delivery of the software.[23]

2.2 Functions of the Agreed Payment Clause

2.2.1 Introduction

Including an agreed payment clause into the contract gives the parties both a clear understanding of what they are protected from and how they are liable to the other

[22] Reinhard Zimmermann, Art 9:509: Agreed Payment for Non-Performance.pp.1539-1540

[23] Peter Benjamin, 'Penalties, Liquidated Damages and Penal Clauses in Commercial Contracts: A Comparative Study of English and Continental Law' (1960) 9 Int'l & Comp LQ 600

party. Not only if they are liable, but also to what extent they are liable to each other. By drafting an agreed payment clause into the contract, the innocent party can make an enforcement in case of a breach of contract more effortlessly. The parties will also know in advance what is the financial cost of breaking the agreed terms of the contract. However, the estimated amount does not include the damages The function of the agreed payment clause is to both bring comfort and to some extent, pressure to the parties to fulfil their obligations.[24]

2.2.2 Explained Functions

Generally, a contract between two or more parties should be built on mutual trust. Drafting an agreed payment clause into the contract does not abolish the good faith between the parties but instead functions as a reassurance and as a risk management clause. [25]

As the contract risks should be mitigated by drafting the contract in mutual understanding, as clear as possible and with realistic outcomes. The risks that can be calculated and seen before hand should be clearly stated in the contract and informed to both parties. This occurs often in construction contracts. The risk of delay should be clearly stated and the outcome of the delay detailed. By making a risk response plan before anything goes wrong, the parties save both time and money if anything happens. [26]

The agreed payment clause may also have a rewarding effect. This means that the contract itself gives the performing party an incentive to honour the agreed terms. An example of a reward clause could be an extra payment for a construction company in case they finish the work before the agreed timeline. By rewarding for overachieving the goals, the construction company has capita to hire more workers and has a motive to earn more. For the ordering party, the reward clause brings perhaps insurance for the agreed terms to be performed, not only properly, but earlier than agreed.[27]

---

[24] Roger Halson, *Liquidated Damages and Penalty Clauses* ,(Oxford University Press, 2018).pp.11-15

[25] Ibid.,14-21

[26] International Chamber of Commerce, *Guide to penalty and liquidated damages clauses*, (ICC Publishing, 1990). pp.16-32

[27] Lisa A Fortin, 'Why there Should be a Duty to Mitigate Liquidated Damages Clauses' (2009). 285-290

2.2.3 Functions of Agreed Payment Clause in Different Types of Contracts

2.2.3.1 Introduction

The agreed payment clause offers liability and certainty for the parties. When drafted into the contract, it makes the enforcement easier in case of a breach of contract. The innocent party will have the agreed payment clause to rely on. By stating the limitations of the liability in the clauses, the parties will know what to expect from each other in case of a non performance, and what they are expected to deliver themselves.[28] In order to have the agreed payment clause enforced, the amount should be modest considering the contract price.

One of the greatest functions of the agreed payment clause is how the clause preserves the ongoing commercial relationship between the parties. In some cases, the parties may have to continue working together even in the case of a breach of contract. By drafting an agreed payment clause to the contract, the breach can be settled effectively. This way the rest of the obligations of the contract can be performed sooner.[29]

The following contract types benefit commonly from the agreed payment clauses. Loan agreements, construction contract and manufacturing contracts.[30] In this chapter, an actual commercial contract is used as an example. The contract is from a Finnish software company which both uses and faces agreed payment clauses in the contracting relationships.[31]

2.2.3.2 Loan Agreements

In loan agreements, it is common to see terms and clauses which could be considered a penalty clause. One example of the previously mentioned case would be when the interest is on a much higher rate compared to a scenario where the loan

[28] Lisa A Fortin, 'Why there Should be a Duty to Mitigate Liquidated Damages Clauses' (2009) 38 Hofstra L Rev 285

[29] Peter Benjamin, 'Penalties, Liquidated Damages and Penal Clauses in Commercial Contracts: A Comparative Study of English and Continental Law' (1960) 9 Int'l & Comp LQ 600

[30] Ugo Mattei, 'The Comparative Law and Economics of Penalty Clauses in Contracts' (1995) 43 Am J Comp L 427

[31] Terms and Conditions for XXXX-company loading computer, 2016

is paid on time.[32] This common feature of interest rates rising are similar in most of the contracts that consider periodic payments. It is called a default interest provision. As a default, most loan agreements include a clause for the borrower to pay 1% to 3 % interest in case they can not pay back in the agreed schedule of payment. Since the interest rate is commonly moderate, it is very unlikely that the clause is going to be challenged as an unenforceable penalty in court. [33]

Despite the new features to remark a penalty clause by the test later explained in this thesis, there has not been significant increases in the interest rates considering loans. Even though, the interest has been kept modest, the court rulings and recent cases have shown that the significantly higher interest rates compared to the common percentage have been upheld by the courts when the circumstances and obvious reasons to support the rate has been presented.[34] An example case of this previously mentioned occasion is the ICICI Bank UK Pic v Assam Oil Co Ltd, where the court accepted the 4% interest rate and argued that it is not too far from the common and modest loan rate used. This case has been judged in US Supreme Judicial Court of Massachusetts. Middlesex. [35]

2.2.3.3 Construction Contracts

An article written by Ugo Mattei, 'The Comparative Law and Economics of Penalty Clause in Contracts', explains the useful benefits of a penalty clause in construction contracts. A party ordering construction work is on a tight schedule to get the work finished by a specific date when the property needs to be in a great condition and ready for the daughter´s wedding. The customer is willing to pay extra money for the construction company to guarantee the work to be done by this date as an insurance. From the customer´s point of view, the extra money paid should be in balance with the contract value considering the work but also high enough to bring comfort and reliability of the work getting done on time. From the contractor´s point

---

[32] Roger Halson, *Liquidated Damages and Penalty Clauses* ,(Oxford University Press, 2018) . pp.200-212

[33] Ignacio Marin Garcia, 'Enforcement of Penalty Clauses in Civil and Common Law: A Puzzle to Be Solved by the Contracting Parties' (2012) 5 Eur J Legal Stud 95

[34] Peter Benjamin, 'Penalties, Liquidated Damages and Penal Clauses in Commercial Contracts: A Comparative Study of English and Continental Law' (1960) 9 Int'l & Comp LQ 600

[35] ICICI Bank UK Plc v Assam Oil Co Ltd and Others: ComC 27 Mar 2019

of view, the extra money received as an insurance payment should be high enough to bring motivation and capita to have an option to hire extra workers to finish the job in the given timeline. [36]

In this type of contract, the penalty clause can be very sufficient and much needed to protect the customer. The penalty fee should be high enough to prevent the construction company from slacking. The greater the penalty is, the more efficiently the work can be expected to be done due to the possible profit loss suffered by the company.[37] In this article, the penalty fee is discussed to be 500 dollars per day of delay. The more the construction company is late, the less profit they would be making from this business deal. Higher penalty fee gives confidence to the customer that the work will be done efficiently. This above-mentioned scenario is called wealth maximizing. [38]

2.2.3.4 Manufacturing Contracts

A Finnish software company referred to as X, coding a software program for the ships and cruises delivers the manufactured product in a computer set. The contracts include both the terms and conditions for the software itself but also clauses regarding the hardware and their delivery. Customer ordering the system often sets the time of the delivery. The ships sail in their agreed schedule, and the system needs to be delivered at the agreed time to the agreed port. In this case, an early delivery is just as inconvenient as a late delivery.

As the company X wants to minimize the possible penalties regarding late and early deliveries, their own terms and condition letter does not include a specific promise of the delivery time. The company states that “the delivery time is 4 to 12 weeks”. The time line is quite broad.[39] Each customer agrees the specific time between the

[36] Ugo Mattei, 'The Comparative Law and Economics of Penalty Clauses in Contracts' (1995) 43 Am J Comp L 427

[37] Mark Wright, Reg Thomas, *Construction Contract Claims,* (MacMillan Education UK, 2016) pp. 200-212

[38] Ugo Mattei, 'The Comparative Law and Economics of Penalty Clauses in Contracts' (1995) 43 Am J Comp L 427

[39] Terms and Conditions for XXXX-company loading computer, 2016

given timeline but the company X does not promise to deliver in the scope of a day but instead in the scope of a week. This depends on the delivery country and region.

The customer Y, who purchases the software system strives to gain some insurance regarding the correct delivery time and has drafted an agreed payment clause of a late performance in to their own terms and conditions letter. The clause states that "in case the hardware is delivered late, the penalty shall be 100 euros per day, starting from seven days after the agreed delivery day. The amount of the penalty shall not exceed the contract price." [40]This clause has a function to both ensure the agreed delivery time and condition and give the customer insurance. The clause also has a function to pressure the company X to perform as agreed in the contract. When the clause is in balance, the outcome should be desired, and both parties benefit from the agreed payment clause. [41]

2.3 Summary

In conclusion, the functions of the agreed payment for non-performance clauses in commercial contracts are to prevent and protect. The clause can provide security for the contracting parties that the agreed terms will be valued and performed accordingly in the agreed timeline.[42] The agreed payment for non-performance clause sum can be negotiated between the contracting parties but should be a moderate sum in comparison to the contract price. Courts have often found the penalty clause unenforceable due to this mentioned reason when parties have set the sum significantly high compared to the common level. [43]

Some contract types benefit from the agreed payment for non-performance clauses significantly much. As mentioned in this chapter those types of contract are loan agreements, construction contracts and manufacturing contracts. All the mentioned contracts include characteristics which require beforehand agreed sanctions for non-performance. [44]

---

[40] Terms and Conditions for XXXX-company loading computer, 2016

[41] Pekka Takki, 'IT-sopimukset, käytännönkäsikirja', 2003. p.135

[42] Ignacio Marin Garcia, 'Enforcement of Penalty Clauses in Civil and Common Law: A Puzzle to Be Solved by the Contracting Parties' (2012) 5 Eur J Legal Stud 95

[43] Roger Halson *Liquidated Damages and Penalty Clauses* ,(Oxford University Press, 2018) . pp.224-227

[44] Ugo Mattei, 'The Comparative Law and Economics of Penalty Clauses in Contracts' (1995) 43 Am J Comp L 427

However, receiving compensation is not always a straightforward process as the damages need to be shown to the court. In some cases, it might be rather difficult to show the amount of damages when the actual damage is for example a loss of time or late delivery, and the monetary damages caused by that are for a third party.[45]

To conclude this chapter, when agreed payment for non-performance clause is drafted in common understanding by following the background law and to match the moderate level, the clause may function as protection, insurance, deterrent or incentive.[46]

[45] Ugo Mattei, 'The Comparative Law and Economics of Penalty Clauses in Contracts' (1995) 43 Am J Comp L 427

[46] Roger Halson, *Liquidated Damages and Penalty Clauses* ,(Oxford University Press, 2018) . pp.200-212

3. Penalty Clause and Liquidated Damages Clause

3.1 Introduction

The term, agreed payment clause includes both penalty clauses and liquidated damages clauses. These two clauses have similar features but in addition to that, significant differences. Penalty clause can often be told apart from liquidated damages clause by considering the modesty of the amount. However, not all jurisdictions allow the usage of penalty clause but those jurisdictions which do, base the validation on the long tradition of the penalty rule.[47] In this chapter, the different features of the penalty clause and liquidated damages clause are explained and similarities analysed. The Cavendish case [48], the Dunlop Pneumatic Tyre v New Garage (1915) AC 79 five step test, is presented and the methods to identify the differences between the two clauses are explained.[49]

3.2 Penalty Clause

3.2.1 Introduction

Contracts may have a penalty clause which states an agreed amount suffered by a party breaching the contracting terms. Penalty clause exists in the contract for a protection of a party which has been violated by the other party by breaching the contract and most importantly, to prevent the violation of contract terms occurring. The penalty clause states the compensation granted to the violated party. Few factors define whether or not the penalty clause is considered enforceable in the contract.[50] The main factor is the background law of the contract but also the amount of the penalty. Even in the legal systems where the penalty clause is

[47] Roger Halson, *Liquidated Damages and Penalty Clauses* ,(Oxford University Press, 2018). pp.11-15

[48] Cavendish Square Holdings BV v Makdessi; ParkingEye Ltd v Beavis [2015] UKSC 67

[49] Dunlop Pneumatic Tyre Co Ltd v New Garage & Motor Co Ltd. (1914) UKHL 1

[50] Reinhard Zimmermann, Art 9:509: Agreed Payment for Non-Performance. pp.1539-1540

enforceable, the amount should be in proportion with the contract price in order to have the clause enforced and considered modest.[51]

3.2.2 Definition of a Penalty Clause

Penalty clause is an old tradition from the English law which states the compensation that the innocent party will enjoy after the other contracting party has breached the contract.[52] By definition the aim of the penalty clause is to prevent the contracting parties from preaching the contracting terms. The amount of penalty in a contract is often greater than the actual loss of the innocent party. In order to be enforced, the penalty clause needs to be properly advised to both of the parties and the general assumption between the parties needs to be that the clause will be enforced in case of a breach. The court often places the decision on the interest of the party seeking for a penalty.[53] Important questions to define are, why is the party seeking the sum of money from an alleged business partner and it this penalty amount truly covering the damages caused by the other party, or is the amount serving a purpose of a punishment. If the penalty amount is only covering damages, the amount should not be significantly larger than the losses. However, this is not often the case. When the penalty clause amount is greater than the loss, the purpose of seeking the agreed sum may instead be to prove a point and show the power over the other party for the future relationships and contracts.[54]

The penalty rule and the usage of it is often protected by the freedom of contract, pacta sunt servanda. However, it is not always certain that the courts will enforce the penalty clause due to the freedom of contract of the parties drafting the contract. The amount is often modified to be more decent and to better match the losses affected by the breach of contract. Whether or not the penalty clause of the contract is enforced by the courts, depends on the position of the clause. The clause can either be a primary or secondary clause. The penalty clause is only enforced if it is proven to be a secondary clause in the English law and in similar jurisdictions. This

---

[51] Ugo Mattei, 'The Comparative Law and Economics of Penalty Clauses in Contracts' (1995) 43 Am J Comp L 427

[52] Peter Benjamin, 'Penalties, Liquidated Damages and Penal Clauses in Commercial Contracts: A Comparative Study of English and Continental Law' (1960) 9 Int'l & Comp LQ 600

[53] Raluca Antoanetta Tomescu, 'Tort Liability. Damages and Penalty Clause' (2018) 7 Persp L Pub Admin 254

[54] Roger Halson, *Liquidated Damages and Penalty Clauses* ,(Oxford University Press, 2018) . pp.200-212

concept is further explained in the chapter six which overviews the technicalities of drafting a penalty clause. [55]

3.2.3 Liquidated Damages Clause

3.2.3.1 Introduction

Liquidated damages clause is used to estimate the compensation in case of a contractual breach and agreed between the contracting parties. They are actualized in the occurrence of a breach of contract. The courts favor these clauses when the possible breach is either possible calculate or the nature of it is certain. The clauses are used to make the process of breach of contract more efficient and inexpensive. This prevents the parties to litigate the damages in court. The liquidated damages should be moderate and match the possible harm caused by the breach.[56]

3.2.3.2 Definition of Liquidated Damages Clause

By definition the liquidated damages clause refers to pre-agreed sum which the breaching party will be expected to pay for the innocent party in case of a non-performance or damages. In construction contracts, this clause would state the amount of money paid for the customer by the contractor in case of a delay. The timeline and sum are agreed between the contracting parties. The milestone can be tied to substantial or final completion of the project.[57]

The difficulty of liquidated damages clause is the necessity to calculate the amount of damages in advance. Rarely the actual damages match the calculated damages and this may lead to an extended dispute resolution which does not benefit either of the contracting parties. This above-mentioned difficulty has led to some parties not wanting to be tied to pre-agreed amount. This is the case when the contracting parties are significantly unsure of the possible damages and the miscalculation

[55] Peter Benjamin, 'Penalties, Liquidated Damages and Penal Clauses in Commercial Contracts: A Comparative Study of English and Continental Law' (1960) 9 Int'l & Comp LQ 600

[56] Brian Eggleston, *Liquidated Damages and Extensions of Time: In Construction Contracts,* (John Wiley and Sons Ltd, 2009). pp.11

[57] Tekelioglu, Numan, 'Penalty Clause and Liquidated Damage in the Construction Contracts,' (Yildirim Beyazit Hukuk Dergisi, Vol. 2017, Issue 2, 2017), pp. 159-188

would cause inefficient and economical outcome. The lack of confidence on calculating the damages beforehand may lead to uncertainty in enforcing the clause in case of a breach of contract.[58]

Over the past decade, liquidated damages clause has become commonly used in commercial contracts. When the use of the clause has become more common, the amount of errors have increased as well. The most common mistakes in use of the liquidated damages clause is in the scope of calculations, administrations and the enforceability. The reason why the liquidated damages clauses have just recently become more common is the development is the court´s view on them. Previously, the liquidated damages clause was often viewed in both courts and dispute resolutions as a penalty clause. The system has then developed and the contracting parties are more comfortable to use the clause in their contracts.[59]

One specific issue which the courts struggle with referring to the liquidated damages clause, is the battle between allowing the freedom of contract to be enforced, and the responsibility to protect the breaching party from not being able to recover the damages. [60] For this mentioned reason, the courts rarely enforce the full damage amount but instead moderate the amount to be more reasonable. After all, the contract evolved between the parties should never lead to one of the parties going bankrupt. Drafting and entering a contract should be based on good faith and therefore the breach of a contract should be solved in good terms as well.

3.2.3.3 CISG Statement Regarding Liquidated Damages Clause

The CISG does not specifically state about the liquidated damages clause but rather allows the contracting parties to freely agree on the fixed sums in their terms. Article 6 of CISG gives the parties the freedom and autonomy to mutually agree on the payment in case of a contractual breach. Article 4 of CISG punctuates the so called ‘validity exceptions’ which sets out the exceptions that affect the autonomy of the parties regarding the freedom of contract. The validity clause points out that

[58] Peter Benjamin, 'Penalties, Liquidated Damages and Penal Clauses in Commercial Contracts: A Comparative Study of English and Continental Law' (1960) 9 Int'l & Comp LQ 600

[59] Clark R. McCormick, ’Make Liquidated Damages Work’, (PE. 2003, AACE International Transactions. CDR.15.) Pg. 1

[60] TAL Fin. Corp. v. CSC Consulting, Inc., 844 N.E.2d 1085, 1093 (Mass. 2006)

not only is the term one of the mentioned categories, but it may also not be in any case valid in some jurisdictions. The general and common view has been concluded to be that when this type of agreement has been made, the contract should be viewed in the light of CISG and enforced as agreed.

Due to the fact, that the international law does not specifically state anything about the penalty rule, it comes to the matter of the national law applied whether or not the clause falls into the category of liquidated damages or penalties. The model rules offer advice and suggestions to implement into use of drafting commercial contracts. This topic is further presented and analyzed in chapter seven.[61]

3.2.3.4 Main Differences Between Penalty Clause and Liquidated Damages Clause

In a case Cavendish Square Holdings BV v Makdessi; ParkingEye Ltd v Beavis [2015] UKSC 67, the Supreme Court of England and Wales stated that in the following scenarios, penalty clauses can be enforced.[62] There is a legitimate purpose, proportionality and the clause is not a primary obligation. If these mentioned characteristics are not fulfilled, the penalty clause can not be enforced. Primary obligation is the main obligation of a contract. On the other hand, secondary obligation rises when the primary obligation can not be enforced and satisfied by the party. [63] The Cavendish case presents an important role regarding the change of ruling of the penalty clause. The case offers detailed information on primary and secondary obligation, and how to tell these two apart.

As stated earlier, it is important to be able to tell the difference between the penalty clause and liquidated damages clause in jurisdiction which generally do not enforce penalty rules. Dunlop Pneumatic Tyre v New Garage (1915) AC 79, judgment given by House of Lords in England, set up a five-step test to determinate the difference. The first step is the name of the clause and whether or not it is relevant but not conclusive. However, it is suggested by the legal

[61] Jack Graves, 'Penalty Clauses and the CISG' (2012) 30 JL & Com 153

[62] Cavendish Square Holdings BV v Makdessi; ParkingEye Ltd v Beavis [2015] UKSC 67

[63] Earl C. Arnold, 'Primary and Secondary Obligations', University of Pennsylvania Law Review and American Law Register, Vol.74. No. 1. (1925). pp.36-71.

professionals to avoid calling a clause in contract a penalty clause. The second step of this theory is to take the greatest possible of loss. If this sum is pre-agreed, extravagant and unconscionable, it is most likely a penalty clause. Thirdly, if the sum payable in the event of non-payment of a sum of money is greater than the sum which should have been paid by the contract, it is considered to be a penalty clause. This means that the recovery is greater than the original value of the contract. The fourth step of the Dunlop Pneumatic Tyre v New Garage is the following. In a case, where the sum of money is pre-agreed for any breach, no matter if it is small or large, likely, but not necessarily the clause is a penalty clause. The last step to determinate the difference is, if precision is not possible, a reasonable attempt at estimating loss does not turn a clause into a penalty. Clearly, there is an overlap in these steps, which might cause some confusion in both the contracting parties and in courts. [64]

After implementing the Cavendish Square method into use, the amount of penalty clauses in finance agreements being held unenforceable has reduced. From this interpretation, it is possible to argue that it may not be necessary to try to draft around the penalty clauses. [65]

To conclude, the main difference between liquidated damage clause and penalty clause is that it is not tied to a damage that can be estimated.[66] The liquidated damages clause includes an amount to be granted to the innocent party in case of a breach of contract. This amount is calculated to the best understanding and estimate of the possible damages caused by a non-performance of the contracting party. As penalty clause is based on the conceit of stating the amount granted to the innocent party in case of a breach of contract, the amount can be significantly higher than the liquidated damages clause offers. The penalty clause is based on a secondary obligation of a contract and the amount can be agreed between the parties but often modified by the court if it is not modest compared to the contract price. [67]

---

[64] Dunlop Pneumatic Tyre v New Garage (1915) AC 79

[65] Cavendish Square Holdings BV v Makdessi; ParkingEye Ltd v Beavis [2015] UKSC 67

[66] Lisa A Fortin, 'Why there Should be a Duty to Mitigate Liquidated Damages Clauses' (2009) 38 Hofstra L Rev 285

[67] Roger Halson, *Liquidated Damages and Penalty Clauses* ,(Oxford University Press, 2018) . pp.200-212

3.3 Summary

In conclusion, the liquidated damages clause presents the estimated amount of damages suffered by the violating party in case of a breach of contract. Instead, the penalty clause serves a different role in the contract, which is to prevent the parties from violating the contract. The penalty clause amount is usually larger than the liquidated damages clause amount, and can only be enforced according to the background law and when the amount is considered modest enough.[68]

The difficulty regarding the liquidated damages clause is the necessity to calculate the amount of damages in advance. Dunlop Pneumatic Tyre v New Garage (1915) AC 79 set up a five-step test to determinate the difference which can help the contracting parties in deciding which clause to use if both are valid according to the contract background law or to recognize the difference between these two clauses. [69] Rarely the actual damages match the calculated damages and this may lead to an extended dispute resolution which does not benefit either of the contracting parties. [70]

Drawing the difference between these two clauses is only necessary in jurisdiction where the penalty clause is not found enforceable. In jurisdictions, like the Nordic law, the difference does not play a significant role because the freedom of contract allows the use of both of the clauses.[71] Similarly as the Nordic law, article 6 of the CISG states about the freedom of contract. The CISG does not specifically state about the liquidated damages clause but rather allows the contracting parties to freely agree on the fixed sums in their terms. Article 4 of CISG states about the exceptions of validity. [72]

In order to effectively use the agreed payment clauses in contract, the proper use and difference is important to recognize. The Cavendish Square case test presented in this chapter offers some guidelines how to recognize the difference in contracting occasions when it matters according to the background law.[73] The usage of both

[68] Reinhard Zimmermann, Art 9:509: Agreed Payment for Non-Performance. pp.1541-1545

[69] Cavendish Square Holdings BV v Makdessi; ParkingEye Ltd v Beavis [2015] UKSC 67

[70] Lisa A Fortin, 'Why there Should be a Duty to Mitigate Liquidated Damages Clauses' (2009) 38 Hofstra L Rev 285

[71] Reinhard Zimmermann, Art 9:509: Agreed Payment for Non-Performance. pp.1541-1545

[72] Jack Graves, 'Penalty Clauses and the CISG' (2012) 30 JL & Com 153

[73] Cavendish Square Holdings BV v Makdessi; ParkingEye Ltd v Beavis [2015] UKSC 67

penalty clause and liquidated damages clause is justifiable in certain types of commercial contracts like construction contracts and loan agreements, but not limited to those mentioned, to offer both security and pressure for the contracting parties.[74]

[74] Reinhard Zimmermann, Art 9:509: Agreed Payment for Non-Performance. pp.1541-1545

4. Validity

4.1 Introduction

Agreed payments for non-performance clauses are frequently used in the commercial contracts. Generally, penalty clauses and liquidated damages clauses are enforced in the civil law countries but only liquidated damages clause is enforced in the common law countries.[79] Finland and other Nordic countries allow the agreed payment clauses to be used and recognize their validity. The Nordic system has treated the penalty clause equally compared to other clauses of the contract.[80] The freedom of contract is one of the leading values in the Nordic legal systems and leaning to that assumption, the penalty clause has been recognized as part of the valid contract elements. [81]

4.2 Validity According to the Background Law

4.2.1 Introduction

Recently presented Cavendish case displays the test to determine the validity of the penalty clauses in the contracts. According to this test presented in the case, the damage clause is not valid if the clause is not proportionate and it does not have actual grounds in the nature of the contract.[82] The damage clause is also invalid when the amount seeked from the damaged party is unreasonably large compared to the actual loss or pre-estimate of the loss. However, the most important factor in determining the validity is to look into the background law of the contract. Other factors mentioned above do not matter in case the background law does not validate the clause in general. [83]

---

[79] Peter Benjamin, 'Penalties, Liquidated Damages and Penal Clauses in Commercial Contracts: A Comparative Study of English and Continental Law' (1960) 9 Int'l & Comp LQ 600

[80] Mika Hemmo, 'Sopimusoikeus I'(1997) Gummerrus. p. 57-61

[81] See for Denmark Art 36 Contracts Act; Finland Section 36 Contracts Act; Norway Art 36 Contracts Act; Sweden § 36 Contracts Act; Iceland Art 36 Contracts Act. Cf also Dimatteo, op cit (n. 5), at p 655

[82] Cavendish Square Holdings BV v Makdessi; ParkingEye Ltd v Beavis [2015] UKSC 67

[83] Peter Benjamin, 'Penalties, Liquidated Damages and Penal Clauses in Commercial Contracts: A Comparative Study of English and Continental Law' (1960) 9 Int'l & Comp LQ 600

4.2.2 Validity According to English Law

In English law, before the Cavendish case, generally only the liquidated damages clauses were enforceable. As it is almost impossible to calculate the amount of damages which may possibly occur in the breach of contract, the liquidated damages clause will be either over or under the actual amount of losses.[84] Interestingly, studies show that under-compensation is more common than overcompensation due to the will of respecting relationships with the clients.[85]

When it comes to the validity of a penalty clause, they were not generally considered valid under English law before the Cavendish case. Cavendish Square Holdings BV v Makdessi; ParkingEye Ltd v Beavis ruling changed the conception to parties being able to enforce compensation beyond just the loss of damages.[86] One of the categorizations of agreed payment clauses is whether the clause is referring to a primary or secondary obligation. If the clause refers to a secondary obligation of the contract, it is considered to be a penalty clause and therefore unenforceable.[87]

However, a penalty like clause may be enforced if the drafting has been considerable and the amount does not exceed a modest amount. An example of this statements is an older case, Alder v Moore (1961), Court of Appeal of England and Wales. In this case, the footballer received an amount of money from the insurance when he gave up his professional football career. However, after receiving the money, he began to play again. The insurance company claimed that the money should be returned back to them and the football player argued that the insurance company is trying to enforce a penalty. The court held that the money requested back was not a penalty because the contract did not ban the football player from playing again. For this mentioned statement, the payment was not conditional to any act, in this case playing again. The footballer was ordered to pay back the insurance company.[88]

---

[84] Peter Benjamin, 'Penalties, Liquidated Damages and Penal Clauses in Commercial Contracts: A Comparative Study of English and Continental Law' (1960) 9 Int'l & Comp LQ 600

[85] Hillel J. Einhorn, Robin M. Hogarth, ’Behavioral Decision Theory: Processes of Judgment and Choice’, Journal of Accounting Research, Vol. 19, No. 1 (Spring, 1981), pp. 1-31

[86] Cavendish Square Holdings BV v Makdessi; ParkingEye Ltd v Beavis [2015] UKSC 67

[87] Sirko Harder, 'Negotiating Damages in English Contract Law' (2020) 14 FIU L Rev 45

[88] Alder v Moore [1961] 2 QB 57

This mentioned case promotes the argument that the penalty clause may be valid if it is drafted correctly, depending on the condition of the contract. However, a clause including penalty clause features may be invalid and considered unenforceable simply by the conditions of the contract.[89]

Validating penalty clauses in the English jurisdiction may bring some efficiency to the process and decrease the confusion between the two agreed payment clauses. The penalty clause has long traditions in the English jurisdiction and for that reason has not, and most likely will not be removed from it completely. It can be argued that the system is not working properly at the current state and some adjustment would be highly appreciated to promote efficacy and clarity. [90]

4.2.3 Validity of Penalty Clause According to Finnish Law

Finnish law follows the same approach as other Nordic countries in the matter of validity of the penalty clause. The distinction between liquidated damages clauses and penalty clauses have not been made in a sense that only one of them would be valid. The Finnish jurisdiction recognizes both of these clauses and treats them as any other clause in a contract due to the respect of the freedom of contract.[91]

The validity is based on the nature of the contract, the relationship between the parties and the balance between them, the circumstances and amount of the penalty clause. A fair penalty clause by all mentioned factors is considered to be valid and enforceable. The courts may reduce the amount of the penalty in a case where the amount is excessive compared to the contract value and the position of the parties.[92]

If the court finds the penalty clause of the contract unfair, the amount can be reduced as stated earlier, or terminated completely. This is related to the occasions when the amount is grossly larger than the actual calculated damages. If the court decides to

[89] Sirko Harder, 'Negotiating Damages in English Contract Law' (2020) 14 FIU L Rev 45

[90] Tareq Al-Tawil, 'English Contract Law and the Efficient Breach Theory: Can They Co-Exist' (2015) 22 Maastricht J Eur & Comp L 396

[91] Mika Hemmo, 'Sopimusoikeus I', (1997). p.57

[92] Antti Hannula, Juha Virmavirta, 'Ohjelmistovienti-sopimusjuridiikan käsikirja'. (1994) p.138

terminate the penalty clause of the contract, the other terms of the contract are also considered again.[93]

Despite the mentioned factors defining the validity, in general, the penalty clause is enforced and treated equally with the liquidated damages clause. This policy promotes efficiency and clarity in contracting relationships and dispute settlements. The distinction between the two clauses is not necessary but prevents the confusion in drafting and enforcing the contracting terms. [94]

However, as stated previously, the leading value in the Finnish contract law is to protect the freedom of contract. The parties have the freedom and responsibility to draft a contract as they wish, in the lines of legality and reasonability. If the contracting parties consider the penalty clause to be necessary in order to protect the parties and the efficiency of the possible ocation of violation of the contract, the penalty clause may be used in the contract and enforced by the court in the lines of reasonability factors mentioned before. [95]

4.2.4 Case Examples of Validity

4.2.4.1 Introduction

In this chapter the concept of primary and secondary obligation is further explained by the example case Holyoake v Candy. In English law, the validity and enforceability is often related to the matter of which category the clause presents. [96]Another example case analysed in this chapter is Diestal v Stevenson, which better actualizes the struggle with calculating liquidated damages during the drafting of the contract.[97] This case was chosen as an example due to the fact that English law does not enforce penalty clause but does not perfectly recognize the issue of insufficient options to protect the innocent party from under-compensation.[98]

---

[93] Finnish Contracts Act, Section 36 (956/1982)

[94] Ibid.

[95] Mika Hemmo, ’Sopimusoikeus I’ (1997) p. 57-61

[96] Holyoake v Candy [2017] EWHC 3397 (Ch)

[97] Diestal v Stevenson [1906] 2 KB 345

[98] Sirko Harder, 'Negotiating Damages in English Contract Law' (2020) 14 FIU L Rev 45

4.2.4.2 Holyoake v Candy

The case Holyoake v Candy is an applicable example of a case where the primary and secondary obligation are explored. The High court of England allowed several fees and payments to be considered as primary obligations despite the party challenging them being penalty clauses.

In 2011, a company owned by Holyoake purchased a property worth 42 million pounds. He took a personal for the time management reasons, worth 12 million pounds from CPC Group Limited, owned by Christian Candy. Holyoake then sold the property in 2014 for 85 million pounds but he was required to pay 37 million to CPC. This sum included loan, interest, a minimum profit share and fees from him extending the loan payment term.

Holyoake brought multiple claims and the judgement is the following. The loan was agreed to pe paid back with early payments but all the interests which the end of the term would include. This was considered to be a primary obligation, and for that reason Holyoake had agreed to pay 17.74 million pounds back to CPC including interests for the 12 million borrowed. In addition to that, the loan was not paid according to the agreed schedule.

Holyoake also claimed that as he was charged double interest and argued this to be a penalty. The judge held that due to Holyoake breaching the terms of payment schedule, the double interest occurred. For this reason he became a credit risk for the loaner and the fee was justified. [99]

The case Holyoake v Candy is presenting a model case of the importance of meaningful drafting of a contract. By clever drafting the clause can be drafted around the penalty rule and therefore enforced. The supreme court judges did agree that when the penalty is showing a true value to the parties and contracting relationship, it is not as easy to draft around it. To simplify the matter, a well required penalty rule is and should not be drafted around easily. The clause should only be used if it brings high value for the parties.[100]

[99] Holyoake v Candy [2017] EWHC 3397 (Ch)

[100] Sirko Harder, 'Negotiating Damages in English Contract Law' (2020) 14 FIU L Rev 45

4.2.4.3 Diestal v Stevenson

Few cases state the result when the actual loss is greater than the amount of the penalty clause. Diestal v Stevenson judgement given in England is a prime example of this scenario. The liquidated damages clause in the contract of this case amounted to 90 dollars but the actual damages were 320 dollars. Therefore, the innocent party were only granted 90 dollars as the pre-agreed clause stated. [101]

When the contracting parties agree to a certain amount to be paid in breach of a contract, they will not recover more or less than the calculated damages grant. This amount is binding and has proven to be almost difficult to match the actual damages suffered. For this reason, the penalty clause offers valid protection in jurisdictions where they are enforced. The under-compensation is common and can be avoided by drafting a penalty clause which presents a modest payment in case of a breach of contract.[102]

4.3 Summary

The agreed payment for non-performance clauses surely serve an important role in commercial contracts. This chapter explained the validity in English and Finnish legal systems, and presented cases to support those arguments. To conclude the validity of the penalty clause, it depends most on the background law of the contract. In English law the primary and secondary obligation category determinates whether the clause is a penalty or a liquidated damages clause. This dividing is a grand factor in enforceability of the damages.[103] The Finnish law considers both clauses to be valid and enforceable when the amount is justifiable and in balance with the contract price. [104]

---

[101] Diestal v Stevenson [1906] 2 KB 345.

[102] Lisa A Fortin, 'Why there Should be a Duty to Mitigate Liquidated Damages Clauses' (2009) 38 Hofstra L Rev 285

[103] Tareq Al-Tawil, 'English Contract Law and the Efficient Breach Theory: Can They Co-Exist' (2015) 22 Maastricht J Eur & Comp L 396

[104] Finnish Contract Act, Section 36 (956/1982)

It may be argued that the benefits of the penalty clause when drafted thoughtfully overcome the risks of the penalty clause. The protection of the weaker party is better accomplished and perhaps prevents the breach of contract occurring. The penalty clause has a valid role in commercial contracts where it is nearly impossible to calculate the actual damages.[105]

[105] Sirko Harder, 'Negotiating Damages in English Contract Law' (2020) 14 FIU L Rev 45

5. Interpretation of the Penalty Clause and Liquidated Damages Clause

5.1 Introduction

This chapter presents the interpretation of both penalty clause and liquidated damages clause during the history and today. The problem of not drawing a clear distinction between these two agreed payment clauses has been present throughout time. The courts and contracting parties continue to struggle with the interpretation which causes inefficient contracting process and lengthy disputing settlements.[106] This issue is more thoroughly presented in two important cases, Dunlop Pneumatic Tyre co Ltd V. New Garage & Motor Co Ltd, and BSNL V. Reliance Communications Ltd, in this chapter. [107] Both of these cases present a ruling in a common law country.

5.2 Interpretation Development of Agreed Payment for Non-Performance

5.2.1 Introduction

The penalty rules have a long history beginning from the Roman times. The jurisdictions which still today enforce the clause rely their decision to continue the enforcement of penalty clause on the history and traditions of the clause.[108] This chapter reviews the original interpretation and use of the agreed payment clause and how this has developed during hundreds of years.

---

[106] Reinhard Zimmermann, Art 9:509: Agreed Payment for Non-Performance. pp.1541-1545

[107] Dunlop Pneumatic Tyre Co Ltd v New Garage & Motor Co Ltd. (1914) UKHL 1

[108] A.W. Brian Simpson, *A History of the Common Law of Contract*, (Oxford University Press) 1987. pp.4

5.2.2 History of the Interpretation of Agreed payment for Non-Performance

The history of European Civil Law on Contracts presents a long history of penalty clauses which have been in use since the Roman times. It could be argued that the rise of the Church and growth of Canon law led to focusing the view in law to morality and specifically in contract law, the focus was on the debtors.[109] This new manner of approach led to elevating the debtor´s position by restricting the penalty clauses to roughly doubling the agreed payments sum compared to the actual damage in loss. However, the golden era of the penalty clauses did not remain unchanged through out the evolution and transition of law. [110]The civil law recognizes the need to keep the penalty clauses separate from the liquidated damage clauses but has commonly reduced the amounts of the penalties to be more modest. Protection of the debtor has since been more balanced between both parties, creating a platform for equal contracting relationships. The first shift regarding the court´s view on the penalty clause has been seen in the German Civil Code, where the court and judges were given the power to evaluate the validity and nature of the penalty clause.[111]

5.2.3 Interpretation Today

Later the European Contract law has been unified by the countries of the union. With small differences in their interpretation of the different aspects of law, the contract law is serving it´s purpose in all European countries with similar jurisdictions. This is beneficial for all the people and companies doing business transactions and contracts with foreign businesses. [112]

As a result of the unifying the legislations, the Principles of European Contract Law, PECL was written. Article 9.509 of the PECL states how the penalty clause should be interpreted in the contract. The above-mentioned clause states first, the definition of the agreed payment for non-performance in case the party fails to perform the agreed actions. The clause continues to specify this in case the agreed payment

[109] Reinhard Zimmermann, Art 9:509: Agreed Payment for Non-Performance. pp.1541-1545

[110] A.W. Brian Simpson, *A History of the Common Law of Contract,* (Oxford University Press) 1987. pp.4-10

[111] Roger Halson, *Liquidated Damages and Penalty Clauses* ,(Oxford University Press, 2018) . pp.200-217

[112] Reinhard Zimmermann, Art 9:509: Agreed Payment for Non-Performance. pp.1541-1551

amount is grossly over the reasonable amount considering the breach and the contract value, the amount paid for the innocent party will be modified by the court.[113] Other model rules, including PICC, DCFR and FS state the similar interpretation of the penalty clause. As the international law does not particularly state anything regarding the penalty clause and the interpretation of it, one should rely on the model rules and the national legislation which is the background law of the contract.

The overall interpretation of the penalty clause is the following. The freedom of contract allows the usage of it but the breaching party is still protected by the court in case the amount is exceeding the reasonable limits.[114] English law, however, has a very different interpretation regarding the penalty rule. [115]

5.2.4 Case Examples of the Interpretation of Agreed Payment for non-performance

5.2.4.1 Introduction

Possibly the most comprehensive judgement regarding the subject of penalty clauses in commercial contracts, is held in the Dunlop Pneumatic Tyre co Ltd V. New Garage & Motor Co Ltd case. This previously named case has become the locus classicus, the most well-known example case presenting the juridical interpretation of the penalty clauses.[116] The difference between liquidated damage clause and penalty clause is causing confusion and causes the process in both courts and between the contracting parties to be less efficient. [117]

Second example case presents both the interpretation of agreed sum clauses and the sometimes confusing distinction between liquidated damages clause and penalty clause. The case BSNL V. Reliance Communications Ltd describes the court´s reasoning of an occurrence where there is no breach of contract, but the

[113] Principles of European Contract Law, 9:509

[114] Reinhard Zimmermann, Art 9:509: Agreed Payment for Non-Performance. pp.1548-1550

[115] A.W. Brian Simpson, *A History of the Common Law of Contract,* (Oxford University Press) 1987. pp.4

[116] Dunlop Pneumatic Tyre Co Ltd v New Garage & Motor Co Ltd [1914] UKHL 1

[117] Lisa A Fortin, 'Why there Should be a Duty to Mitigate Liquidated Damages Clauses' (2009) 38 Hofstra L Rev 285

unauthorised call are violating the level playing field and by that causing damages.[118]

5.2.4.2 BSNL V. Reliance Communications Ltd

Case BSNL V. Reliance Communications Ltd represents an occurrence where it is questionable whether the innocent party can recover from an event which is not a breach of contract but is not consistent with the obligations granted by the contract. This judgment has been given by the Supreme court of India. India is a common law country with some traces of civil law features. This case has been chosen to further explain the procedure in common law countries other than England.

Two companies had entered into a BSO Interconnect Agreement, meaning they shared a network. BSO regime was replaced in India in 2003 by another company. The networking company charged for the call depending on the nature of the calls. The price was different between local and international call. This information was gained by CLI, Caller Line Identification system. The CLI served an important purpose when identifying the rate of the phone call for the billing. In 2004, BSNL investigated the system ad found out that the identification was tampered and international calls were masked as local calls.

Firstly, the supreme court found that this case is an odd example of a case where it does not matter whether the agreed sum payable clause is a penalty clause or a liquidated damage clause. This was due to the fact that the clause in the contract stated the following: *"sum payable on the happening of an event other than breach".*[119] Considering this statement, the court needed to grant the compensation to the innocent party, which would not exceed the agreed sum. It could be argued the court treated the clause as a liquidated damage clause since the calculation was considered to be pre-estimated and respectful. [120]

[118] BSNL V. Reliance Communications Ltd (2010)
[119] Ibid.
[120] Ibid.

5.2.4.3 Dunlop Pneumatic Tyre co Ltd V. New Garage & Motor Co Ltd case

This case is a model example of the problem of recognizing the difference between liquidated damages clause and a penalty clause. In Dunlop Pneumatic Ty co Ltd V. New Garage & Motor Co Ltd case, the claimant is a manufacturer and supplier of the sold goods. The respondent is a dealer who was accused of selling a product manufactured by the claimant, under a list price advised to him. The judgment has been given by House of Lords in England.

The claimant argued that the respondent is liable to pay a sum stated in their contract after the respondent sold the goods under the agreed price and therefore breached the contract terms. The respondent is defending himself by stating that the agreed payment for non-performance clause is in fact a penalty clause and cannot be enforced.

The court first found that the claimant was correct and the clause was a liquidated damages clause and therefore enforceable. The case was taken to the Court of Appeal and the judgement was for the favour of the respondent. The Court of Appeal found the same clause now to fulfil the characteristics of a penalty clause.[121]

This case was disputed in the English court and the contract background law was English law. It is a great example of how confusing the separation of penalty clause and liquidated damages clause can be for the courts and contracting parties. The outcome of this case supports the arguments of the importance of clear and unequivocal system to tell apart these two clauses. [122]

5.3 Summary

To conclude, the juridical interpretation of the penalty clauses, drawing a difference between penalty clause and liquidated damages clauses has become rather difficult for the courts. Not only is the distinguishing difficult, it is also time consuming. It could possibly be argued that the numerous Supreme court judgments have made it

[121] Dunlop Pneumatic Tyre Co Ltd v New Garage & Motor Co Ltd. (1914) UKHL 1

[122] Neil Andrews, *Contract rules: decoding English contract law.* (Cambridge:Intersentia, 2016). pp.7.13

confusing to spot the difference and possibly has adopted the worst of both worlds into the common law rules regarding this subject. The model cases have created uncertainty to which category does the clause belong to and in addition to that, has not created certainty of the principle of civil law enforcement.[123]

In order to have a fully functioning and efficient process, there should be a clear definition and ruling between abusive and efficient penalty clauses.[124] In addition to that, the clear difference between liquidated damages clause and penalty clause must be drawn. It could be argued that the courts should enforce the penalty clauses in the event of efficiency but not when the clause is abusive. The clause can be viewed as abusive when the amount is significantly high or the consequences are unbearable for the suffering party. [125]

[123] Reinhard Zimmermann, Art 9:509: Agreed Payment for Non-Performance. pp.1548-1550

[124] Ugo Mattei, 'The Comparative Law and Economics of Penalty Clauses in Contracts' (1995) 43 Am J Comp L 427

[125] Ignacio Marin Garcia, 'Enforcement of Penalty Clauses in Civil and Common Law: A Puzzle to Be Solved by the Contracting Parties' (2012) 5 Eur J Legal Stud 95

6. Adjustment

6.1 Introduction

The use of penalty clause is often protected by the freedom of contract, which is a right that most countries grant in their legal systems. A person drafting a contract can purposely draft a penalty like clause around the penalty rules, if one adjusts the interpretation correctly. This can only be considered in legal systems which do not recognize the penalty clause validity. However, drafting around the penalty rule is not recommended. In general, the contracts can be adjusted to be more efficient for all parties by following certain steps and rules.[126] Precisely, the freedom of contract could be argued to give the right to draft the contract however desired as long as the terms are agreed and understood by both or all parties involved, and the background law is respected.[127] A valid contract can be drafted and adjusted only by following the background law of the contract. [128]

6.2 Efficient Contract

6.2.1 Introduction

The process of drafting, entering, and honouring a contract could be made more efficient and unified by few changes in the systems and paradigms. Mattei presents the four step, efficient model of commercial contracts in an article "Efficiency in Legal Transplants. An Essay in Comparative Law and Economics". By following the presented four steps, the contracting parties could elevate the contracting relationship and enable a positive outcome. [129]

6.2.2 Adjusting into the Efficient Model

In the ideal legal system, the following four guidelines would be commonly used for their shown benefits in the model. First of the guidelines being allowing a person

---

[126] Ugo Mattei, 'The Comparative Law and Economics of Penalty Clauses in Contracts' (1995) 43 Am J Comp L 430-432

[127] Richard Epstein, *Fall and Rise of Freedom of Contract*, (Duke University Press, 1999). pp. 289-300

[128] Mika Hemmo, 'Sopimusoikeus I', (1997) p.57-61

[129] Ugo Mattei, 'The Comparative Law and Economics of Penalty Clauses in Contracts' (1995) 43 Am J Comp L 427

to insure themselves when entering a contractual agreements regarding non-satisfactory results. The second step would be to let all individuals to state their reliability for the other parties in the specific market sector. Thirdly, it would be beneficial for all parties to follow the rule 'pacta sunt servanda', which means that all obligations stated in the contract are binding by law to all the contracting parties. Lastly, all parties would do their best to avoid litigation as the courts are significantly crowded at this time.

Even though these guidelines would bring all modern legal systems together in processes and benefit the legal institutions, the reality is far from the optimal at this moment. The current performance has been seen almost as a competition between the legal systems thriving by the lawyer´s ideology instead of the reasoned policy considerations. The civil law countries are far from perfect regarding this topic, but their actions can be viewed less inefficient compared to the common law legal systems. [130]

When striving to find an efficient model, it is typical to combine the comparative law and economic theories and then fit this model into the real world problems and legal systems. The goal is to explain why a particular inefficiency exists and how it can be avoided. In order for the efficient system to work properly, in all occasions the freedom of contract regarding the penalty clause should be available. As known, the freedom of contract can be limited in numerous of way but one of the restricted nature of contract is to not create externalities to either of the contracting parties nor to the possible third parties involved in the contract. From the efficiency point of view, one of the goals of contract law would not be to grand complete freedom of contract but instead make the transaction efficient. [131]

6.2.3 Freedom of Contract

The freedom to use and enforce penalty clauses should be, according to some scholars, retained in the common law jurisdictions. This should be maintained even

[130] Ugo Mattei, 'The Comparative Law and Economics of Penalty Clauses in Contracts' (1995) 43 Am J Comp L 427

[131] Luanda Hawthorne, 'Freedom on Contract: Constitutional Realisation of Substantive Freedom' (2016) 2016 SUBB Jurisprudentia 48

if the contract includes a liquidated damages clause. It could be argued that the courts are simply avoiding the task to calculate the mitigation and the non-breaching party does not have to show any efforts to avoid loss. The above mentioned scenario promotes inequality by granting the total liquidated damages amount to the non-breaching party and does not encourage the parties to mitigate. This allows the breaching party to make a profit while penalizing the other contracting party. It is also pointed out that in addition to the mentioned arguments, this system does not promote good faith, which is one of the founding values in contract law.[132]

The freedom of contract and retaining of the interest of the parties are perhaps the most crucial areas of contract law and society. Courts should act accordingly to protect the contracting parties and not allow litigations to over rule damages. After all, this process is proven to be more expensive. As a rule, the parties should be encouraged to mitigate in all occasions. By following this rule, the mitigations are triumphant, the contracting parties remain in good terms and excessive assets are not lavished. In such case when the mitigation does not lead to a satisfying solution, the non-breaching party will be covered by the liquidated damages clause. The benefits of this procedure over lap the inconvenience caused to the courts which need to consider mitigations case-by-case. [133]

6.2.4 Drafting a Penalty clause

6.2.4.1 Introduction

The difference between liquidated damages clause and penalty clause is not always clear. This can be viewed as a problem but could be considered to be a possibility for the contracting parties. In case the parties wish to draft a penalty like clause in to the contract but the jurisdiction does not allow penalties. The drafting party can draft around the penalty rule and still include some type of agreed payment for non-performance into the contract. This chapter overviews difficult scenarios when it has been challenging to show whether a clause is a penalty or liquidated damages

[132] Richard Epstein, *Fall and Rise of Freedom of Contract,* (Duke University Press, 1999). pp. 289-321

[133] Lisa A Fortin, 'Why there Should be a Duty to Mitigate Liquidated Damages Clauses' (2009). 285-290

clause, and presents practices of how to draft the agreed payment clauses for the proper need of them.[134]

6.2.4.2 Category of the Penalty Clause

As stated earlier, the Supreme Court holds the power to decide whether or not a penalty clause in forceable or not. For this reason, the person drafting the contract holds a great power whether the plan is to let a clause fall to the category of a penalty clause or to liquidated damages clause.[135] Few of the next examples are representing problematic provisions in contracts and is only applicable in those jurisdictions which do not generally enforce penalty clauses.

The first example is from a corporate agreement, more particularly shareholder agreement. The term bad leaver-clause is presenting a case when a person holding a manager position in a company decides to leave the company and is required to give up his or her shares for less than their market price is. This described request can be considered to be a penalty.[136]

Another example of a clause acting as a penalty clause could be from an oil and gas joint operating agreement. The clauses are forfeiture clauses which could require the defaulting party in case of a failure to provide security or a cash call would have to transfer their interest to the non-defaulting party to their joint venture. This action without any compensation posses features of a penalty clause or can be considered to be a penalty clause.

Even if a clause has some features which lean torch the penalty clause definition, the clause can be justified as a liquidated damages clause by keeping the amount reasonable and the action which the clause refers to as a primary obligation. By simply drafting around the defining rules, the clause can still include the pressuring or protecting features with out the penalty rule definition. However, it is required to consider that jurisdictions which do not allow penalty rules will not accept rules that are very similar to them. In order for the clause to be passed as a damage clause,

---

[134] Roger Halson, *Liquidated Damages and Penalty Clauses* ,(Oxford University Press, 2018) . pp.200-212

[135] Earl C. Arnold, 'Primary and Secondary Obligations', University of Pennsylvania Law Review and American Law Register, Vol.74. No. 1. (1925). pp.36-71

[136] Mark Anderson, Victor Warner, *Drafting and Negotiating Commercial Contracts*,(Bloomsbury Publishing PLC, 2016). pp. 21-43

it must be modest and reasonable in all levels and by the understanding of all parties.[137]

6.3 Summary

To conclude the defencing argument for penalty clauses and how they should be adjusted is to primarily protect and further promote efficiency. The contracting relationship should be agreed on terms which make both the agreed transaction and business plan safe, efficient and profitable.[138] Whether or not this mentioned plan includes a penalty rule is a responsibility of the parties. The freedom of contract protects this option and gives the parties variety of choices regarding drafting of the contract within the lines of the chosen jurisdiction. [139]

The most extravagant contractual terms will not be enforced by the court in case the other party contradicts them. However, the penalty rule does serve a legitimate purpose in some occasions and for the sake of efficiency and functionality should be allowed to serve that part. The adjustment which could be made regarding the penalty rule is the clear difference regarding the liquidated damages clause, as it is never optimal to have people finding ways around the law. The clear distinction between the two clauses and agreed occasions to use them would give both the courts and contracting parties confidence to draft and enforce the agreed payment clauses. [140]

The freedom of contract will continue to protect the use of the penalty clause and whatnot, the decision to not use it.[141] It can be argued to the great extent whether the penalty clause is valid for the purpose of it but the certain types of commercial contracts and areas of business will most likely continue to both need and use the clause for the sake of freedom of contract. [142]

---

[137] Roger Halson, *Liquidated Damages and Penalty Clauses* ,(Oxford University Press, 2018) . pp.200-219

[138] Ugo Mattei, 'The Comparative Law and Economics of Penalty Clauses in Contracts' (1995) 43 Am J Comp L 427

[139] Richard Epstein, *Fall and Rise of Freedom of Contract,* (Duke University Press, 1999). pp. 289-300

[140] McCormick, Clark R, 'Make Liquidated Damages Work', AACE International Transactions.(2003). pp.1

[141] Mika Hemmo, 'Sopimusoikeus I', (1997) p.58

[142] Richard Epstein, *Fall and Rise of Freedom of Contract,* (Duke University Press, 1999). pp. 289-300

7. Damages According to the Background Law

7.1 Introduction

The common law courts may declare unenforceable some of the penalty clauses that define the agreed payment in the case of a breach of contract. In the common law countries, generally, the principle of non-enforcement regarding penalties is broadly used. The main purpose of using penalty clauses is to make sure that the contractual promises are respected.[143] The main difference compared to the common law features is the fact that civil law jurisdictions allow the use of agreed payment clauses but may only reduce the sum in case the amount is considered excessive. The amount considered as modest varies in different parts of the world.[144] This chapter overviews the use of penalty clause according to English law and Finnish law. These two different views have been chosen to present the different approaches which have been referred to during this thesis.

7.2 Differences in English law and Finnish law

7.2.1 Introduction

The main difference between English Law and Finnish law regarding the agreed payment for non-performance is that English law did not enforce the penalty clauses before the Cavendish case.[145] Despite the change regarding the enforcement of penalty clauses after the mentioned case , it is significantly important to draw the difference between penalty clause and liquidated damages clause in the English jurisdiction and similar jurisdictions.[146] In the Nordic countries, the agreed payment clauses are generally treated as any term of the contract. If the term is fair considering the rest of the contract and all the applicable factors, the penalty rule is

[143] Ugo Mattei, 'The Comparative Law and Economics of Penalty Clauses in Contracts' (1995) 43 Am J Comp L 427

[144] Bruno Zeller, 'When Is a Fixed Sum Not a Fixed Sum but a Penalty Clause' (2012) 30 JL & Com 173

[145] Roger Halson, *Liquidated Damages and Penalty Clauses* ,(Oxford University Press, 2018) . pp.200-212

[146] Jack Graves, 'Penalty Clauses and the CISG' (2012) 167

enforced.[147] This chapter presents the main differences of the chosen jurisdiction regarding this matter.

7.2.2 Implications of Penalty clause in English law

Penalty clause has long traditions in the English law. The difference between English law and other jurisdictions in this case is that the English law does not recognize the concept of punitive or special damages.[148] In 2015 the Supreme court judges Lord Neuberger and Lord Sumption changed the legal test for penalty clause and by that reformulation, more clauses became unenforceable and ineffective under the English law. Generally, penalty clause was not enforceable in the English legal system before the Cavendish case. The classical theory of penalty clause does apply similarly to the liquidated damages clause. The conclusion is, as stated earlier, the liquidated damages require a sum calculated at the time of drafting the contract.[149]

The formulated legal test is firstly based on the analyze whether the impugned provision falls into the category of secondary or primary obligation.[150] The interest should not be to punish the contracting party but to simply require the proper and agreed performance of the contracting terms. The involved judges have described the penalty rule as an old concept which does not properly serve the needs of today in the contract law. However, the judges did not advice the rule to be removed completely as in some interpretations it serves a traditional role in the English law and has long principles. Despite the so-called ancient reputation of the penalty rule, it may still be useful when protecting the innocent party in the contracting agreement where the balance between the parties is unequal. In the above-described occasion, the penalty rule minimizes the risks and allows the weaker party to have some negotiating power against the significantly stronger contracting party.[151]

---

[147] O. Lando, *Restatement of Nordic Contract Law*, (Copenhagen, Djøf Publishing, 2016) 95-110

[148] John Baker. *Introduction to English Legal History*, (Oxford University Press, 2019). pp.200-213

[149] Peter Benjamin, 'Penalties, Liquidated Damages and Penal Clauses in Commercial Contracts: A Comparative Study of English and Continental Law' (1960) 9 Int'l & Comp LQ 600

[150] Earl C. Arnold, 'Primary and Secondary Obligations', University of Pennsylvania Law Review and American Law Register, Vol.74. No. 1. (1925). pp.36-71

[151] Tareq Al-Tawil, 'English Contract Law and the Efficient Breach Theory: Can They Co-Exist' (2015) 22 Maastricht J Eur & Comp L 396

The supreme court argued that the freedom of having a penalty rule is important when it comes to the concept of freedom of contracts. It works most beneficially in relationships when both parties entering the contract are working in good faith and well-informed. This way the penalty clause will most likely be left unused as the agreed terms should be fulfilled respectfully.[152] In general, regarding the commercial contracts, both parties should share a great confidence in honoring the contract and therefore the clause does not have to be enforced. [153]

7.2.3 Primary and Secondary Obligations

Generally speaking, the penalty clause only applies to the secondary obligations of the contract. The primary obligation should be considered as a stand-alone obligation and secondary obligation is only considered in case the contractual breach appears. This can be considered as an alternative to damages. Despite the original stipulation of the obligation, the courts have stated that the contract will be reviewed and the real nature of it is investigated in a case of a contractual breach.[160]

What the contract creating parties can do in order to prevent the clause to fall into the scope of the penalty clause, is to structure the obligations to match the primary obligation definition. At the same time, the penalty clause should be drafted so that it is not disguised and there fore unenforceable. In some cases, drafting a contractual provision as a primary obligation may not always be the most desired goal in contracts. The person drafting the contract may come to this conclusion in a occurrence when parties desire to maintain the possibility to collect the agreed amount from penalty clauses in common law jurisdiction. In case of a breach of contract, the courts will consider the nature of the contract and whether the penalty rule is fitting to the purpose. In a case where the drafter has made the clause a

[152] Andrew Burrows, *Remedies for Torts, Breach of Contract, and Equitable Wrongs*, (Oxford University Press, 2020). pp. 32-37

[153] Peter Benjamin, 'Penalties, Liquidated Damages and Penal Clauses in Commercial Contracts: A Comparative Study of English and Continental Law' (1960) 9 Int'l & Comp LQ 600

[160] Earl C. Arnold, 'Primary and Secondary Obligations', University of Pennsylvania Law Review and American Law Register, Vol.74. No. 1. (1925). pp.36-71

secondary obligation, the focus should be on not fulfilling the other elements of the penalty clause test. [161]

As the freedom of contract is one of the fundamental strengths of the English law and most other legal systems, it may also make the contractual relationships and drafting contracts more complex than it first appears. [162]

7.2.4 The Finnish Contract Law Approach

Both the Finnish and English law recognize the mutual consensus of the parties to honor the contract terms. At the same time, both of these legal systems pursue to protect the weaker party protection.[163] The Finnish law gives the judges the responsibility to view and analyze the penalty and liquidated damage clauses under the clause 36 of the Finnish Contracts Act. In the English law, this approach is stated in the penalty rule. [164]

The Finnish Contracts Act states the following of the agreed payment for non-performance in the section 36 (956/1982). When considering the fairness of the term, the amount can be adjusted or even unenforced. The determining of fairness is analyzed by the content of contract, the relationship and balance between the parties, the circumstances of the breach and other appearing factors. If it appears that one or several of the factors mentioned above are considered unfair, the entire contract and the terms of it may be adjusted or in severe occasions terminated. The amount stated in the agreed payment clause may be deemed a contract term. [165]

According to the Finnish contract law, the involved parties may agree to have a penalty clause as an insurance for the innocent party´s protection. The penalty clause is performed not by the legal grounds but by the agreement between the

[161] Peter Benjamin, 'Penalties, Liquidated Damages and Penal Clauses in Commercial Contracts: A Comparative Study of English and Continental Law' (1960) 9 Int'l & Comp LQ 600

[162] Richard Epstein, *Fall and Rise of Freedom of Contract,* (Duke University Press, 1999). pp. 289-300

[163] O. Lando, *Restatement of Nordic Contract Law,* (Copenhagen, Djøf Publishing, 2016) 95-110

[164] Finnish Contract Act, Section 36 (956/1982)

[165] Finnish Contract Act, Section 36 (956/1982)

contracting parties. For this reason, the penalty clause must be agreed in the contract in order to be binding. [166]

The Nordic countries typically present the civil law systems which do not aim to draw the difference between penalty clause and liquidated damages clause. This is due to the fact that the jurisdictions allow the use of both of these clauses and therefore the difference does not affect the enforceability. [167]

7.3 Model Rules

National jurisdictions differ from each other when it comes to the validity of agreed payments for non-performance. When drafting a contract, it is important to rely on the background law chosen to bind the agreement. As stated earlier, the difference between liquidated damages clause and penalty clause is only needed to be set in jurisdictions which do not allow the enforcement of penalty rules. Jurisdiction which allow and validate both types of agreed payment clauses do not define difference. Even though, the universal separation by definition is similar in all countries, the difference may not be relevant in some legal systems. [168]

There are no international rules regarding agreed payments for non-performance. However, there are model rules which address this matter. The model rules have taken an approach which is closer to the civil law approach than the common law approach.[169] The model rules in PECL 9:509[170], PICC 7.4.13[171], DCFR III.-3:712[172] and FS 170 all state about the agreed payment in practically identical matter. The conclusion of all the above-mentioned rules is the following. The party who fails to perform the agreed task is to pay the innocent party a sum agreed in the contract. If the agreed sum is excessive, the court will make a ruling to moderate the sum in the light of the contract. [173]

---

[166] Mika Hemmo, 'Sopimusoikeus I', (1997) p.57

[167] O. Lando, *Restatement of Nordic Contract Law*, (Copenhagen, Djøf Publishing, 2016) 95-110

[168] Reinhard Zimmermann, 'Art 9:509: Agreed Payment for Non-Performance'. pp.1539-1540

[169] Reinhard Zimmermann, Art 9:509: Agreed Payment for Non-Performance. pp.1545-1549

[170] Principles of European Contract Law, 9:509

[171] Principles of International Commercial Contracts, 7.4.13

[172] Draft Common Frame of Reference, III.-3:712

[173] Reinhard Zimmermann, Art 9:509: Agreed Payment for Non-Performance. pp.1545-1549

The goal is to find an international consensus and functioning system and for that reason it is interesting that CESL and CISG do not provide any advice regarding this important matter.[174] UNCITRAL (A/CN.9/243, annex I) has stated model rules under 'Uniform Rules on Contract Clauses for an Agreed Sum Due upon Failure of Performance'. The mentioned set of rules has not led to international convention but has been used as a recommendation.[175] The recommendation in 1983 was part of the General Assembly of the United Nations and the motive was to suggest the member states to reflect on the rules and consider implementing them into their practice.

To conclude the description of model rules, PECL, PICC, DCFR and FS all include statement regarding the agreed payment for non-performance in a similar matter. The rules are not limited to only liquidated damages clauses but identically apply to penalty clauses.[176]

7.4 Summary

Damages according to background law seem to follow a similar trait. The core values in determining a fair contract term are part of all the jurisdictions and often affects most the enforcement of the clause. However, the English law did not generally enforce penalty clauses even though the clause has been part of their contracts law for hundreds of years. But this has changed after the Cavendish case reformulation. [177]

The Finnish law and English share some similarities regarding the penalty rule. Both jurisdictions pursue to protect the weaker party from the unfair terms. The amount of the agreed payment clause is often reduced to match a modest level considering the contract price and the character of it. Both jurisdictions state the effectiveness as one of the core values in contracting relationships. [178]

[174] Bruno Zeller, 'Penalty Clauses: Are They Governed by the CISG' (2011) 23 Pace Int'l L Rev 1
[175] UNCITRAL , (A/CN.9/243, annex I)
[176] Reinhard Zimmermann, Art 9:509: Agreed Payment for Non-Performance. pg.1539-1548
[177] Sirko Harder, 'Negotiating Damages in English Contract Law' (2020) 14 FIU L Rev 45
[178] Reinhard Zimmermann, Art 9:509: Agreed Payment for Non-Performance. pg.1539-1548

The main differences of the two analysed jurisdictions is the fact that the English law did not enforce the penalty clause before the Cavendish case but the Finnish law treats those clauses as any other clause in the contracts. The Cavendish reformulation in the English doctrine could be simplified to the following. The doctrine is not against penalties in contracts but attacks the secondary obligations. This reformulation is done to protect the weaker party and to balance the bargaining relationship of the contracting parties.[179] In the Finnish law, the difference between the penalty clause and liquidated damages clause does not matter because both of them are treated similarly and enforced if all the requires features are fulfilled but in English law and in similar jurisdictions, the difference is significant.[180]

The international law does not state anything about the validity or interpretation of the penalty rule. However, all the model rules state about the penalty rule very similarly. PECL 9:509[181], PICC 7.4.13[182], DCFR III.-3:712[183] and FS 170 suggest suggested that a party drafting a contract considers the model rules and implement them to use.

To conclude the chapter, all jurisdictions have some types of penalty rules in their contract law. The rules state somewhat similar terms but also have very different features and enforcement policies. The most important factor when drafting and analysing a penalty rule is to consider the fair and modest outcome of it while following the background law. [184]

[179] Cavendish Square Holdings BV v Makdessi; ParkingEye Ltd v Beavis [2015] UKSC 67

[180] Finnish Contract Act, Section 36 (956/1982)

[181] Principles of European Contract Law, 9:509

[182] Principles of International Commercial Contracts, 7.4.13

[183] Draft Common Frame of Reference, III.-3:712

[184] Reinhard Zimmermann, Art 9:509: Agreed Payment for Non-Performance. pp.1545-1549

8. Summary and Conclusions

In this thesis, one of the research questions was the validity and benefits of the penalty clause. The outcome of the research question was not solely on the features of the penalty clause making it valid or invalid, but instead the background law granting the clause validation.[185] In this thesis English law was applied as an example jurisdiction to represent a legal system which does not generally enforce penalty clauses[186] and Finnish law as an example of a jurisdiction which generally enforces the penalty clause[187].

Both penalty clauses and liquidated damages clauses are enforced in the civil law countries but only liquidated damages clauses are enforced in the common law countries. However, the Cavendish reformulation has impacted the enforcement in English law significantly. [188] Finland and other Nordic countries allow the agreed payment clauses to be applied and recognize their validity equally as any other contracting clause is recognized. [189]Agreed payments for non-performance clauses are frequently used in the commercial contracts and the benefits are clear. A carefully drafted penalty clause promotes efficiency in the settlement process.[190]

National jurisdictions differ from each other when it comes to the validity of agreed payments for non-performance. When drafting a contract, it is important to rely on the background law chosen to bind the agreement.[191] One of the foundings of this research was that the difference between liquidated damages clause and penalty clause must be determined only in jurisdictions which do not allow the enforcement of penalty rules. Jurisdiction which allow and validate both types of agreed payment

[185] Reinhard Zimmermann, 'Art 9:509: Agreed Payment for Non-Performance'. pp.1539-1540

[186] John Baker, Introduction to English Legal History, (Oxford University Press, 2019). pp.200-213

[187] O. Lando, Restatement of Nordic Contract Law, (Copenhagen, Djøf Publishing, 2016) 95-110

[188] Cavendish Square Holdings BV v Makdessi; ParkingEye Ltd v Beavis [2015] UKSC 67

[189] O. Lando, Restatement of Nordic Contract Law, (Copenhagen, Djøf Publishing, 2016) 95-110

[190] Roger Halson, Liquidated Damages and Penalty Clauses ,(Oxford University Press, 2018) . pp.231-233

[191] Reinhard Zimmermann, 'Art 9:509: Agreed Payment for Non-Performance'. pp.1539-1540

clauses, do not define the difference. Even though, the separation by definition is similar in all jurisdictions, the difference is not relevant in all legal systems. [192]

However, a clear outcome of the research is that the liquidated damages clause is almost impossible to calculate to match the actual damages. The calculation is most commonly lower than the actual losses and without a penalty clause, the innocent party will be therefore under-compensated. This may cause a lengthy dispute settlement between the parties and does not promote an efficient contracting relationship. [193]

The benefits gained from using agreed payment for non-performance clauses in the commercial contracts are security and protection to receive proper compensation from the breaching party, insurance and clear agreed obligations for both of the parties.[194]

The outcome of this research is the following. The enforceability of the penalty clause depends on the background law of the contract, the contract type, the nature of the relationship of the contracting parties and the modesty of the penalty amount. The clause is most beneficial when drafted in a common understanding between the contracting parties and for a valid need. The penalty clause is most beneficial to the parties when the amount is modest, fair and in balance with the contract price. The presented adjustment and remedies are concerning most the efficiency of the process. A well drafted agreed payment clause enables an efficient and economical process and outcome. [195]

[192] Roger Halson, Liquidated Damages and Penalty Clauses ,(Oxford University Press, 2018) . pp.200-212

[193] Peter Benjamin, 'Penalties, Liquidated Damages and Penal Clauses in Commercial Contracts: A Comparative Study of English and Continental Law' (1960) 9 Int'l & Comp LQ 600

[194] Reinhard Zimmermann, ‘Art 9:509: Agreed Payment for Non-Performance’. pp.1539-1540

[195] Ugo Mattei, 'The Comparative Law and Economics of Penalty Clauses in Contracts' (1995) 43 Am J Comp L 427

Reference list

Literature

Andrew Burrows, *Remedies for Torts, Breach of Contract, and Equitable Wrongs,* (Oxford University Press, 2020). pp. 32-37

A.W. Brian Simpson, *A History of the Common Law of Contra*ct, (Oxford University Press) 1987. pp.4

Brian Eggleston, *Liquidated Damages and Extensions of Time: In Construction Contracts,* (John Wiley and Sons Ltd, 2009). pp.11

International Chamber of Commerce, *Guide to penalty and liquidated damages clauses,* (ICC Publishing, 1990). pp.16-32

John Baker, *Introduction to English Legal History,* (Oxford University Press, 2019). pp.200-213

Mark Anderson, Victor Warner, *Drafting and Negotiating Commercial Contracts,*(Bloomsbury Publishing PLC, 2016). pp. 21-43

Mark Wright, Reg Thomas, *Construction Contract Claims,* (MacMillan Education UK, 2016) pp. 200-212

Neil Andrews, *Contract rules: decoding English contract law.* (Cambridge:Intersentia, 2016). pp.7-13

O. Lando, *Restatement of Nordic Contract Law,* (Copenhagen, Djøf Publishing, 2016) 95-110

Richard Epstein, *Fall and Rise of Freedom of Contract,* (Duke University Press, 1999). pp. 289-300

Roger Halson, *Liquidated Damages and Penalty Clauses* ,(Oxford University Press, 2018). pp. 11-15,120-131,200-219, 224-227,231-233

Antti Hannula, Juha Virmavirta, ‘Ohjelmistovienti-sopimusjuridiikan käsikirja’.. (1994) p.107-112, 138

Mika Hemmo, ’Sopimusoikeus I’(1997) Gummerrus. p. 57-61, 150-153

Pekka Takki, ’IT-Sopimukset, käytännönkäsikirja’ (2003). p.135-139

Articles

Bruno Zeller, 'When Is a Fixed Sum Not a Fixed Sum but a Penalty Clause' (2012) 30 JL & Com 173

Clark R. McCormick, ’Make Liquidated Damages Work’, AACE International Transactions.(2003). pp.1

Earl C. Arnold, ’Primary and Secondary Obligations’, University of Pennsylvania

Law Review and American Law Register, Vol.74. No. 1. (1925). pp.36-71

Hillel J. Einhorn, Robin M. Hogarth, ’Behavioral Decision Theory: Processes of Judgment and Choice’, Journal of Accounting Research, Vol. 19, No. 1 (Spring, 1981), pp. 1-31

Ignacio Marin Garcia, 'Enforcement of Penalty Clauses in Civil and Common Law: A Puzzle to Be Solved by the Contracting Parties' (2012) 5 Eur J Legal Stud 95

Jack Graves, 'Penalty Clauses and the CISG' (2012) 30 JL & Com 153

Lisa A Fortin, 'Why there Should be a Duty to Mitigate Liquidated Damages Clauses' (2009). 285-290

Luanda Hawthorne, 'Freedom on Contract: Constitutional Realisation of Substantive Freedom' (2016) 2016 SUBB Jurisprudentia 48

Peter Benjamin, 'Penalties, Liquidated Damages and Penal Clauses in Commercial Contracts: A Comparative Study of English and Continental Law' (1960) 9 Int'l & Comp LQ 600

Raluca Antoanetta Tomescu, 'Tort Liability. Damages and Penalty Clause' (2018) 7 Persp L Pub Admin 254

Sirko Harder, 'Negotiating Damages in English Contract Law' (2020) 14 FIU L Rev 45

Tareq Al-Tawil, 'English Contract Law and the Efficient Breach Theory: Can They Co-Exist' (2015) 22 Maastricht J Eur & Comp L 396

Tekelioglu, Numan, ’Penalty Clause and Liquidated Damage in the Construction Contracts,’ (Yildirim Beyazit Hukuk Dergisi, Vol. 2017, Issue 2, 2017), pp. 159-188.

Ugo Mattei, 'The Comparative Law and Economics of Penalty Clauses in Contracts' (1995) 43 Am J Comp L 427

Reinhard Zimmermann, ‘Art 9:509: Agreed Payment for Non-Performance’. pp.1539-1540, 1541-1545, 1546-1552

Legal Instruments

CESL, Common European Sales Law, Article 86

CISG, International Sale of Goods, Articles 4 and 6

Denmark Art 36 Contracts Act

Draft Common Frame of Reference, III.-3:712

Finnish Contracts Act, Section 36 (956/1982)

Iceland Art 36 Contracts Act

Norway Art 36 Contracts Act

Principles of European Contract Law, 9:509

Principles of International Commercial Contracts, 7.4.13

Sweden § 36 Contracts Act

Terms and Conditions for XXXX loading computer, 2016

UNCITRAL, Uniform Rules on Contract Clauses for an Agreed Sum Due upon Failure of Performance, (A/CN.9/243, Annex I)

Cases

English cases

Alder v Moore [1961] 2 QB 57

Cavendish Square Holdings BV v Makdessi; ParkingEye Ltd v Beavis [2015] UKSC 67

Diestal v Stevenson [1906] 2 KB 345.

Dunlop Pneumatic Tyre Co Ltd v New Garage & Motor Co Ltd. (1914) UKHL 1.

Holyoake v Candy [2017] EWHC 3397 (Ch)

ICICI Bank UK Plc v Assam Oil Co Ltd and Others: ComC 27 Mar 2019.

Indian Case

BSNL V. Reliance Communications Ltd (2010)

US. Case

TAL Fin. Corp. v. CSC Consulting, Inc., 844 N.E.2d 1085, 1093 (Mass. 2006)