A P P E N D I X C

Explanatory Memorandum

Introduction

1. The legal systems of all Council of Europe member States contain rules relating to penal clauses in civil law. Such clauses are also very frequently used in practice and appear in many forms. Considering that a study of this question was of international interest the European Committee on Legal Co-operation (CCJ) proposed that it should be included in the legal programme of the Council of Europe. The CCJ observed in particular that the harmonisation of the rules in this field would both contribute to legal certainty in international commercial relations and facilitate the application of international agreements relating to the recognition and enforcement of foreign judgements.

2. At the request of the CCJ, the International Institute for the Unification of Private Law (UNIDROIT) first prepared a study setting out the existing legislation on penalty clauses in member States and a number of national and international drafts. The study also contained a recapitulation of the various problems which would be involved in harmonising the relevant but often divergent rules.

3. In 1974 the Committee of Ministers, on the proposal of the CCJ, decided to set up a Committee of Experts with the task of drawing up an international instrument on penalty clauses which might take the form of a convention providing for a uniform law.

4. Between 1974 and 1976 the Committee of Experts held four meetings in the course of which it decided that a resolution containing recommendations to member States of the Committee of Ministers, rather than a convention, would be the most appropriate instrument in this field and drew up the text of such a draft resolution. It also prepared the text of the explanatory memorandum relating to the draft Resolution.

5. At the outset the Committee of Experts discussed the legal position relating to penalty clauses in member States taking into account developments in the law subsequent to the completion of the UNIDROIT study. It appeared that several member States

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were in the process of reviewing their laws in this field or had recently adopted new legislation. The Committee also paid particular attention to the Benelux Convention on Penalty Clauses which was signed at the Hague on 26 November 1973 but has not yet entered into force.

6. One of the fundamental questions which the Committee had to tackle was the definition of a "penal clause". It was observed that the survey of the current laws of member States showed that, generally speaking, the notion of penal clause had two different characteristics, namely:

a. the penal clause stricto sensu whose main purpose was to act as a threat to induce the promisor to perform his obligation and punish him if he fails to do so; and

b. a clause which contained a genuine pre-assessment of damages owed by a promisor who fails to perform his obligation (or to use another term, liquidated damages).

7. It was further observed that the treatment of these two aspects of the penal clause, insofar as they could be distinguished, varied considerably from one member State to another. The view was expressed that it was almost impossible to draw a clear distinction in many cases between the two aspects and that the same clause might often have a dual purpose.

8. In this context the difficulty arose that in a small number of member States a penal clause stricto sensu was either void or would not be enforced by the courts eg on the grounds that it was contrary to morality or public policy, while the laws of all other member States allowed such clauses. On the other hand, there was general agreement that, if the penal clause provided for a genuine pre-assessment of damages it should in principle be enforced.

9. The Committee did not find it useful to draw up rules aiming at a harmonisation of the laws of member States which applied to liquidated damages alone. Neither would it, in the Committee's opinion, serve any purpose to draw up such rules which made it possible to set aside all penal clauses stricto sensu. The rules proposed by the Committee are therefore based on the idea that sums due under penal clauses stricto sensu are also normally recoverable.

10. The Committee was fully aware that a change of the law with regard to the enforcement of penal clauses stricto sensu might create considerable difficulty in some member States which do not at present enforce such clauses. It took note in particular of the work of the English Law Commission on the subject of penalty clauses and forfeiture of monies paid in the course of which

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account was being taken of the Committee's work. The Committee was informed that the trend of this work which was still in progress showed a preference for maintaining, on the whole, the present law with regard to penalty clauses and liquidated damages. The Committee expressed its understanding of the difficult position of the United Kingdom experts and regretted that it had not proved possible fully to reconcile the different approaches to the question which reflect divergent approaches to damages for breach of contract, of which the present subject is only a subordinate part, and to the role of the judiciary in this context. In this connection, it should also be stressed that under the terms of the Resolution, member States are merely invited to take these rules into consideration when preparing new legislation in this field.

General considerations

11. The most common form of a penal clause providing for the payment of a sum of money by one party to a contract to the other in the event of the former's failure to perform his obligation under the contract. For reasons of clarity and simplicity the rules set out in the Appendix to the Resolution have expressly been drafted with this situation in mind. It is, however, clear that there are many other clauses which may have the same effect or aim. Thus, for example, a clause providing for forfeiture of money paid as a deposit or a clause providing for a loss of bonus for early performance after a certain time-limit may have the same effect as a clause providing for the payment of a penalty for breach of contract. Under paragraph 2 of the operative part of the Resolution member States are therefore invited to consider the application of the provisions to other clauses with the same aim or effect. Similarly member States may wish to consider whether the rules should be applicable to penal clauses stipulated in connection with juristic acts other than contracts.

12. The legal systems of all member States provide special rules for penal clauses in connection with certain types of contracts. In order to take account of these situations a provision relating to such rules has been included as Article 8.

Commentary on the specific provisions in the Appendix to the draft Resolution

Article 1

13. This article is based on Article 1 of the common provisions annexed to the Benelux Convention (1). It recognises that the purpose of the penal clause may be to provide either for a pre-

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(1) A penalty clause is any clause which provides that if the promisor fails to perform his obligation he shall be bound to pay a sum of money or do some other thing by way of penalty or compensation.

assessment of damages or for a true penalty irrespective of loss. This means that it is not necessary for the purpose of the provisions to distinguish between the two categories. In some countries such a distinciton forms an integral part of the law and is made without undue difficulty. However, in other countries whose law has developed along different lines and which form the majority of those represented on the committee, the distinction would be difficult to drew because it is considered that the reason for inserting a penal clause in a contract may be both a wish to facilitate the assessment of compensation and to provide an incentive for the promisor to perform. It should also be observed that the rules concerning judicial control set out in Article 7 apply to all penal clauses, as defined by Article 1, and the significance of the distinction will therefore be reduced.

14. For the reasons given above in paragraph 11 the article only mentions payment of a sum of money as this is undoubtedly the most common form of penalty. The parties are of course free to agree that if the promisee fails to perform the principal obligation he shall be bound to do something other than paying a sum of money.

Article 2

15. It is obvious that the penalty is not due if performance of the principal obligation as specified in the contract has been obtained. Article 2 means that the promisee who has not yet obtained performance **cannot** obtain from the court judgment for both such performance and the penalty.

16. An exception is, however, made for the case where that sum has been stipulated to ensure that the obligation is performed in time. It has also been considered whether or not, in addition to delay, an express exception should also be made for the situation where performance has either been defective or partial. It appears, however, that, under the law of some member States, a defective or partial performance would not constitute performance. Under the law of other member States a partial or defective performance might be considered as a form of delayed performance. Moreover, the laws of certain member States do not generally entitle the promisee to obtain specific performance to remedy a defect in the performance of the principal obligation. A reference to partial or defective performance in the text of the article has therefore not seemed necessary or desirable. In view of the meaning given to the concepts of "performance" or "delay" in their laws member States may provide expressly that the rule relating to delayed performance applies to partial or defective performance also.

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17. The provisions of this article should be mandatory regardless of whether the penal clause provides for liquidated damages or for a true penalty. In the former case there is no room for compensation if the obligation has actually been performed in conformity with the contract. Similarly, it would be unreasonable to allow the promisee to claim at the same time both the stipulated penalty and performance of the principal obligation.

Article 3

18. The article makes it clear that the mere existence of a penalty clause in a contract is not to be interpreted as meaning that the parties have selected the penalty as the sole remedy for failure to perform the obligation. Accordingly the promisee may, unless the parties have agreed otherwise, always make a choice between asking for performance and claiming the sum stipulated in the penal clause. If the promisee does not have this choice, he would be forced to choose the penalty which amounts to giving the promisor a right to choose payment of the penalty rather than performance of his obligation. It would then be a matter of alternative obligations or of an option to rescind and not of a penal clause. In this case the provisions of the present resolution should not be applicable. This is the significance of the words "of itself".

Article 4

19. The penal clause is normally not a warranty clause but only designed as a sanction for non-performance of the obligation in circumstances where the promisor is liable for the failure to perform. This rule should not however be mandatory and the parties are therefore free to agree that the penalty agreed upon should be due irrespective of the reasons for the failure to perform.

20. The liability of the promisor under the penal clause should be governed by the general rules applicable to contracts under the law of each member State.

Article 5

21. The provisions of this article govern the relation between the penal clause and damages. Acoording to Article 5 the promisee is not entitled to damages instead of or in addition to the sum stipulated in the clause. In other words he may not normally choose between the penal clause and damages as the clause has been agreed upon by the parties in order to provide a specific sanction for non-performance. This rule should not, however, be mandatory and the parties can, if they wish, agree that the sum due under the penal clause shall set a minimum for the damages.

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Article 6

22. This article is based on the idea that it is reasonable to impose an upper limit on the sum which the promisee can obtain if the promisor fails to perform his obligation. This limit is determined by either the sum stipulated in the penal clause or by the damages payable for failure to perform, whichever sum is the larger. As this rule is mandatory it also applies to the situation where the parties have availed themselves of the possibility of setting aside the non-mandatory provisions of Article 5.

Article 7

23. The most important function of the penal clause is to avoid the need to have recourse to judicial proceedings in order to obtain an assessment of damages for failure to perform the obligation. Much expence and difficulty is otherwise often caused in particular by the necessity of producing proof of the loss for which damages are to be paid. The logical consequence of this would obviously be to enforce all penal clauses but this would in some cases lead to results which would be difficult to accept. The legal systems of member States have therefore devised various means to enable the courts to exercise a certain control over penal clauses although the circumstances under which this control can be exercised differ considerably from one State to another. Because of the importance of this question, it is one of the essential aims of the present Resolution to contribute towards a harmonisation of the laws of member States on this point. It should, however, be recalled that one of the major divergencies between these laws at present arises from the fact that under the law of certain member States (Belgium and the United Kingdom) the courts do not have any general power to refuse to enforce a genuine liquidated damages clause but only to set aside a clause which is found to impose a true penalty. The courts in such States have only the choice of awarding the stipulated sum or damages provided by law, and cannot award a sum which is neither of these as would be the result of increasing or decreasing the stipulated sum. While this approach deserves full understanding it cannot fruitfully be reconciled with the approach of the legal systems in the majority of member States which confer a wider power on the courts with regard to penal clauses. In the choice between the two approaches preference has therefore been given to the majority view.

24. Article 7 lays down the criteria which the courts should apply when exercising their power of judicial review with a view to reducing the sum stipulated in the penal clause. The main purpose of the clause (ie to discourage litigation) would be lost if the court could set it aside too easily and the court should

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therefore exercise its power with much discretion. In order to indicate the exceptional character of judicial intervention, a number of formulae have been discussed. In addition to the term proposed namely "manifestly excessive" other terms such as "exorbitant", "unconscionable" (in French "abusive"), "unreasonable" were considered. However, the term "exorbitant" was felt to restrict too narrowly the power of judicial review; the term "unconscionable" was considered insufficiently precise within the context of judicial review of penal clauses; the term "unreasonable" in English was found when used in this connection to have no acceptable equivalent in French legal terminology. The Committee therefore finally decided in favour of the term "manifestly excessive" which is in fact already used in the existing legislation of some member States.

25. While Article 7 lays down the general principle, it only expressly refers to one situation where it may be particularly justified to reduce the sum stipulated in the penal clause, namely where the obligation has been performed in part. It is evident that it would in many cases be excessive to require a promisor to pay the full penalty although the promisee has in addition obtained the benefit of partial performance. In this connection, it may be observed that the laws of some member States (see eg the recent amendment of Article 1152 of the French Civil Code) confer a wider power on the courts to reduce penalties in this particular situation and allow reduction to take place even if the penalty is not "manifestly excessive".

26. It is left to each legal system to determine under what precise circumstances the sum concerned should be considered to be manifestly excessive. It is, however, suggested that, that in a given case the courts may have regard to a number of factors such as:

i. damage pre-estimated by the parties at the time of contracting and the damage actually suffered by the promisee;

ii. the legitimate interests of the parties including the promisee's non-pecuniary interests;

iii. the category of the contract and the circumstances under which it was concluded in particular the relative social and economic position of the parties at the conclusion or the fact that the contract was a standard form contract;

iv. the reason for the failure to perform the obligation in particular the good or bad faith of the promisor.

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27. This list of criteria to be taken into account should not be regarded as exhaustive, nor does it indicate any order of priority. When applying the criteria, regard must also be had to the general law of contracts in the member State concerned which may exclude or limit the possibility of using a particular criterion. It is clear, however, that the most important case is that when the stipulated sum is clearly disproportionate to the loss suffered by the promisee. Nevertheless the mere fact that the loss actually sustained is less than the sum stipulated by the parties at the time of making the contract shall not be sufficient reason for the reduction of the penalty.

28. The article does not include any rules concerning evidence and in particular as regards the burden of proof. These questions are linked to the general rules of civil procedure and evidence in each member State and it would not be possible or desirable to attempt to harmonise them in the present context. It would, however, appear that most legal syatems would place the burden of proof on the person who claims that the clause should be modified or set aside. Article 7 does not deal with the question whether or not the court should have a power to reduce ex officio or of its own motion the sum stipulated in the penal clause, for example in the situation where the promisor fails to take part in the proceedings. National systems should therefore be free to make provision for such an ex officio reduction in appropriate cases. There is, however, no suggestion that national systems which do not at present recognise such a power should change their law in this respect.

29. It was thought necessary to impose a limit on the power of reduction of the court and a provision to this effect has therefore been inserted in Article 7. According to this provision the sum may not be reduced below the damages payable for failure to perform the obligation.

30. The rules in Article 7 concerning judicial control should be mandatory. The protection of the partiet which the provisions are designed to ensure would otherwise rapidly become ineffective in practice as standard form contracts would undoubtedly tend to include a clause excluding them from such control.

Article 8

31. As stated in paragraph 12 above the legal systems of all member States provide special rules for penal clauses in connection with certain types of contracts eg hire purchase. Usually these rules are intended to protect persons in a weak contracting position.

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32. It is neither possible nor desirable to attempt to deal with all these special situations in a resolution relating to penal clauses in general. It is therefore not suggested that the present rules should interfere with such special rules which already exist or may become necessary in relation to particular types of contracts, including standard contracts. A provision indicating this has therefore been included in Article 8. In this connection note has also been taken of the work of the CCJ and the Committee of Experts on the Legal Protection of Consumers which resulted in the adoption by the Committee of Ministers in November 1976 of Resolution (76) 41 on unfair terms in consumer contracts and an appropriate method of control.

33. The articles appended to the Resolution do not (as for example Article 3 of the common provisions annexed to the Benelux Convention) provide any provisions concerning notice to perform or other requirements before the penal clause can be enforced. These matters relate closely to the law of civil procedure of each member State and it would go beyond the practicle limits of the present resolution to attempt to harmonise these often very divergent rules within this context.

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