

The Mystery of Penalties & Liquidated Damages

(a comparison between German and English Law)

By Marion Clark and David Williams / 08 July 2015

Many business people (and lawyers!) are confused by the concepts of penalties and liquidated damages. Some say every contract should have a penalty clause for delay, others consider penalties legally void. When you ask the lawyers they typically provide the answer that any non-legal person dislikes the most: "It depends!" Unfortunately they are right. Whether a penalty in a contract is legally permissible and to what extent, or what the pitfalls for liquidated damages are, depends on the applicable law and the circumstances of the contract. It is therefore important for business people (and lawyers) to understand the difference between penalties and liquidated damages and the circumstances under which a penalty clause or liquidated damages clause will be valid. Applicable law plays a significant role: this article compares Germany as a typical civil code jurisdiction and England/Wales as a typical common law jurisdiction.

I. German law:

Penalties ("Pönale", "Vertragsstrafe" or "Konventionalstrafe") for breach of contract are not peculiar to German law; they are a typical element of German and many other civil code legal systems. Where the parties want to pre-define specific amounts to be paid by a party in the event of breach of contract, German law originally only foresaw the application of penalties. Liquidated damages were introduced into the civil code as part of the law governing "Allgemeine Geschäftsbedingungen", or "AGB" (General Terms and Conditions) but are also permissible in contracts that are individually negotiated.

Penalties fulfil two purposes: one is to put pressure on the contractor to fulfil the contract on time, the other is to compensate the customer for losses in case of breach by the contractor. It is, however, not necessary for the application of a penalty that the customer actually suffered any loss. Consequently the customer could claim delay penalties, in particular penalties for interim milestones, even though there was no negative impact on the customer due to the contractor's delay. On the other hand, the contractor will not have to pay penalties if the delay is not the contractor's fault – there is no liability for penalties in the absence of fault.

Liquidated damages ("pauschalierter Schadenersatz") are also allowed (instead of or indeed in addition to penalties) – the main purpose in this case is the compensation of the losses suffered by the customer. Hence, if the customer did not suffer any loss, or a significantly lower loss, the contractor may be entitled to have the liquidated damages reduced or set aside.

How do you know whether your clause is a penalty clause or a liquidated damages clause? If you use the term "penalty" (or the German equivalent), it is likely that the clause will be considered as a penalty clause. If, however, the contractor is expressly entitled to prove a lower loss or

absence of loss, or if the amounts stipulated are defined as representing a genuine pre-estimate of the anticipated loss, the clause would probably be considered as a liquidated damages clause.

In many cases the question whether the amounts payable are considered as a penalty or liquidated damages does not play a significant role because both legal instruments are allowed under German law and the amounts specified for the breach are typically the same. There are of course exceptions to this rule. These exceptions apply in case the customer is using standard general terms and conditions (“Allgemeine Geschäftsbedingungen”, “AGB”). These are terms and conditions that are frequently used by the customer (using them 2 or 3 times is sufficient!) in the same or similar form. This applies even for major construction contracts where customers have a set of standard commercial conditions that they use for their projects. Where the clause is considered a ‘general term or condition’, a special law applies in Germany which sets out stricter rules for the operation of penalties and liquidated damages:

- Penalties exceeding 5 % of the contract price are not allowed – in this case the whole clause is void.
- Liquidated damages exceeding the typical loss in the relevant industry may be set aside
- The contractor is entitled to prove that the losses suffered by the customer were much lower than the liquidated damages or no loss was suffered. In this case the liquidated damages payable may be reduced or set aside

And how does the interaction between penalties and liquidated damages work? Often you will find a combination of penalties and liquidated damages in a contract - the one does not exclude the other. For example, the contractor will be subject to delay penalties of 0.1 % of the contract price per day up to a maximum of 5 % of the contract price. After the penalty cap has been reached the customer can also demand liquidated damages of 0.2 % of the contract price per day with a cap of 10 % on liquidated damages. The total cap for delay would amount to 15 % of the contract price in this case. If liquidated damages are applied in parallel with the penalties, the penalties have to be deducted.

In other cases, there is only a penalty clause in the contract. This leads most people to believe that the liability for the breach is then limited to those penalties. However, if the contract does not explicitly exclude further remedies for the breach and even if there is a cap for the penalties, the customer will still be entitled to receive, in addition to the penalties, any further actual losses (damages) he has suffered as a result of the breach. While the law requires that any damages actually applied be reduced by the amount of the penalty paid, there is no cap for the additional damages unless this cap is defined expressly in the contract. If, on the other hand, the contract foresees liquidated damages and includes a cap, it is more likely that the customer would not be entitled to additional damages. As this question has not been finally decided by the courts, it is advisable to include a clause defining the liquidated damages as exclusive remedy.

In summary it can be said that penalties and liquidated damages are both allowed under German law but both the customer and the contractor have to be careful to avoid the pitfalls in each case. The customer may lose its entitlement by sloppy drafting, by imposing excessive amounts or when using standardised general terms and conditions, while the contractor may find himself facing liability for penalties as well as liquidated damages or damages at large (unlimited damages at law).

II. English/Welsh law:

The international language of football helps to illustrate the starting point so far as the law of England and Wales is concerned. Don't score an own goal: don't fall foul of the "rule against penalties". The rule provides that, to the extent that a contractual clause is a penalty, it will be completely unenforceable. Fundamentally, therefore, the underlying principles of English and German law differ.

A contract clause will be a penalty, and therefore unenforceable, if it provides for payment of a sum and the predominant purpose is to deter a party from breaching its contractual obligations. However, a clause will be enforceable, if the payment stipulated amounts to a genuine pre-estimate of loss arising in the event of a breach, as that is deemed not to be a penalty provision, but a provision for liquidated damages. Needless to say, such clauses, where they are enforceable can have the distinct benefit of providing some certainty as to exposure and risk in the event of a breach of contract and there is no obligation for an aggrieved party to take steps to mitigate their loss, as would be the case in a claim for unliquidated damages, and issues as to foreseeability of loss do not arise.

Liquidated damages clauses under English law are also something remarkable, in that usually, to recover damages, a claimant must prove that it was owed a duty under the relevant contract, the duty was breached, and that it suffered loss. However, where there is a valid liquidated damages clause and a claimant establishes a breach of duty within the scope of that clause, the claimant is entitled to the payment regardless of whether, or to what extent, any loss has actually been suffered. This is one area in which English and German law (in respect of penalties) have a common approach.

The key issue is to determine whether a 'payment on breach' provision is in reality an unenforceable penalty clause or an enforceable liquidated damages clause. The following key legal principles have developed under common law, through cases decided in the courts, and show what you should watch out for when negotiating or reviewing your contracts:

- The terminology used is not conclusive. Regardless of the words used, it is the actual nature of the payment stipulated which determines whether it is in truth a penalty.

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- A clause will be a penalty if the sum stipulated is extravagant and unreasonable in comparison with the greatest loss that could conceivably be proved as flowing from the breach.
- Payment of a single sum in the event of multiple or different breaches of varying severity gives rise to a presumption of a penalty.
- Determining whether a clause is a penalty is a matter of contractual construction to be resolved by considering the pre-dominant function of the clause at the time the contract (or the provision in question) was agreed.
- Penalties may not always be in the form of a typical money payment – they could involve other benefits in kind, for example, the transfer of shares or the release of contractual obligations, or the forfeiture of a payment otherwise due.
- Just to make things more complicated, however, there are also some interesting exceptions:
 - The rule against penalties is an anomaly because it is a limit on the freedom of parties to contract with each other as they wish. Therefore, where a provision is discussed and freely negotiated between two commercial parties of equal bargaining power, the courts will be reluctant to find that a clause is unenforceable.
 - Commercial justification can be crucial. Even if the effect of a clause is penal, the provision might be enforceable, depending on the commercial circumstances. In a recent case, a clause providing for the payment of a substantial fee was held not to be a penalty because the payment became due in various commercial circumstances, not just in the event of breach, and because inclusion of the fee was justified in a contract which was completed in a challenging economic climate.
 - Even liquidated damages clauses, which on their face are stated as having been calculated on the basis of a genuine pre-estimate of loss, are vulnerable to attack if they operate in a way which in fact punishes the breaching party. By way of example, in a shipping case the court considered a clause in a shipping contract that specified liquidated damages to be paid if shipping containers were used for longer than intended. However the contract was not time limited and when a breach occurred, the aggrieved party claimed continuing damages even beyond the period during which it suffered loss. The Court held that, despite being an apparently valid liquidated damages provision, the fact the clause could operate in its way meant that it was penalty in nature.

As with German law, depending upon the specific contractual provisions there may be scope for further remedies for the breach in question unless there is a cap for the liquidated damages.

As is evident from the general principles outlined above, while those principles are well established, they can invariably be difficult to apply to the factual scenarios in many contracts,

without a very detailed analysis of the application of those principles. Even then, cases on the issue as to the distinction between a penalty and liquidated damages come before the courts frequently and indeed one particular case will be heard by Supreme Court in the summer of 2015, which will provide an opportunity for some of the key legal principles to be considered and further clarified or refined.

III. Summary – Key Principles

German Law	Law of England & Wales
Penalties are allowed – one purpose of penalties is to deter the parties to breach the contract.	"Rule against penalties" because pressure to deter a breach is not allowed.
Liquidated damages/genuine pre-estimate of loss provisions are enforceable.	Liquidated damages/genuine pre-estimate of loss provisions are enforceable.
Penalties can be payable regardless of actual loss suffered. Liquidated damages can be payable in addition to penalties.	Liquidated damages can be payable regardless of actual loss suffered.
Terminology is not conclusive. The nature and extent of a clause will determine whether it is a penalty or provides for liquidated damages.	Terminology is not conclusive. The nature and extent of a clause will determine whether it is a penalty or provides for liquidated damages.
Contractual construction and commercial context will be relevant as well as the intention of the parties.	Contractual construction and commercial context will be relevant. The intention of the parties, unless evident from the contract wording, is not usually a factor which can be taken into account.

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