Content:

No. VI.4 - Promise to pay in case of non-performance

When the contract contains a clause providing that a party who fails to perform is to pay a specified sum to the aggrieved party for such non-performance, the aggrieved party is entitled to that sum irrespective of its actual loss. If the amount is grossly excessive in relation to the loss resulting from non-performance, and the other circumstances, the specified sum may be reduced by an arbitral tribunal or court to a reasonable amount notwithstanding any agreements of the parties to the contrary.

Commentary:

1 The Principle covers a broad range of clauses which can be categorized as penalty clauses ("clause pénale"; "Vertragsstrafeversprechen") and liquidated damages clauses ("Schadenspauschalierung") under many domestic laws. Under common law, penalty clauses are considered invalid due to their in terrorem effect, intended to put pressure on the debtor as an incentive for timely performance. Some civil law systems, such as German law, contain provisions which invalidate penalty clauses when they are contained in standard terms.

2 In international business, these clauses are extremely often used because time is of the essence for the seller or the ordering party who has resold the goods before he has received them from his seller or is under some other type of time pressure which makes timely performance essential. For that reason, these types of clauses are not regarded as invalid per se in transnational law.

3 In line with the very purpose of such clauses, the agreed sum is forfeited, irrespective of the actual loss suffered by the aggrieved party. This means that the non-performing party cannot escape its obligation to pay the agreed sum by arguing that the aggrieved party has sustained a smaller loss than the sum agreed upon in the clause or no loss at all.

4 If, however, the agreed sum is grossly, i.e. clearly and obviously, excessive in relation to the loss caused by the non-performance and also in relation to the other circumstances of the case, the non-performing party may apply to the court or arbitral tribunal to have the sum reduced to a reasonable amount, even if the parties have excluded that right by agreement. In determining whether the sum is grossly excessive, the court or arbitral tribunal necessarily enjoys a certain degree of discretion. The power of the court or arbitral tribunal is limited to a "reduction" of the sum, which excludes both a total elimination (a "reduction to 0") and an increase of the agreed sum.