PENALTY CLAUSES IN INTERNATIONAL ARBITRATION: A COMPARATIVE SNAPSHOT

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I. INTRODUCTION

The topic of penalty clauses (or "liquidated damages" in a different formulation) has particular relevance in international law and, more particularly, in international arbitration. Indeed, one can hardly deny the international character of the issue at stake. In international trade and, more particularly, cross-border transactions and major projects, the crucial importance of contractual provisions to the effect of limiting and/or excluding liability, on the one hand, and to set forth the amounts due in case of breach of the contract, on the other, is of undeniable relevance. I dare to say that these contractual stipulations are one of the core subjects of any international agreement.

Parties need to control their contractual risk and be set free from any particularity arising from local laws and jurisprudence that may inflate damages in case of a non-performance or breach of contract. On the other hand, parties also need to fix the amount that would be due in such contractual pathological cases to avoid discussing the actual damages suffered (evidence of which is always hard to establish).

Additionally, often times it is the case that the parties need "incentives" to fulfill their obligations and to deter non-performance. However, there are some jurisdictions where the limitation or exclusion of liability clauses and *forfaitaire* liability clauses (clauses either fixing the damages via a "liquidated damages" clause or by providing a "penalty") are questioned, if not altogether prohibited. Those legal obstacles may often be tackled by providing a law that does not raise questions as to its validity and enforceability, coupled with arbitration agreements

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that prevent parties from resorting to local state courts, which may well have divergent views.

Be that as it may, the fact is that the operation of the invalidity or non-enforceability of such clauses may occur in a subsequent phase of the process when an award creditor seeks to obtain the recognition and enforcement of such award. Indeed, the jurisdiction where the recognition and enforcement of the award is sought may well consider these clauses as violating its international public policy.

Against this backdrop, in this article, I will try to address the issue of penalty clauses in international arbitration. First, I will provide a broad overview of the concept, underlying interests, and kinds of penalty clauses (II). I will then present an overview of the legal framework in many jurisdictions, including both civil law and common law perspectives, alongside a few specific Latin American jurisdictions (III). Then, I will move to consider whether or not legal rules in international law, and general principles of law, apply in this regard (IV); what the state of affairs is in international arbitration case law (V); and whether or not one can draw any conclusions from general principles of law (VI). I will subsequently address the issue of public policy and the impact it may have on international arbitral awards (VII).

II. CONCEPT, RELEVANCE, AND KINDS OF PENALTY CLAUSES

Before I proceed, one caveat should be explained. This article only addresses the issue of penalty clauses and not the clauses providing for limitation and exclusion of liability. This consideration is noteworthy because penalty clauses often make their appearance in contracts under the guise of a limitation of liability, an exclusion of liability, or even a mix of those stipulations. Further, and according to the function that it is performing in a contract, the penalty clause may also play the actual role of "liquidation of damages." It is, thus, not surprising that some national legislation dealing with these kinds of clauses label them as a "penalty" but actually provide a legal framework for liquidation of damages.

In any case, and for this reason, it is worth making a distinction between limitation and exclusion of liability clauses, on the one hand, and liquidated damages and penalty clauses, on the other, so that the latter are singled out.

In the first set of clauses—limitation and exclusion of liability—parties may wish to exclude their liability arising from possible delayed performance or non-performance of their contract. To the extent permitted by law, the parties' liability will be subject to exclusion: in the event of delayed performance or non-performance, the debtor will not be liable to the creditor. This is an exclusion of liability clause, under which the parties, in anticipation of a dispute, exclude their liability that would otherwise exist without any restriction and covering every possible damage, no matter its extension or value. An example of a clause excluding liability is as follows (usually appearing in capital letters):

> Exclusion of liability. To the extent permitted by applicable Law, none of the parties hereto shall assert, and each party hereby waives, any claim against each of the other parties and their respective affiliates, members of the board of directors, employees, attorneys, agents or sub-agents, on any theory of liability, arising out of, in connection with, as a result of, or in any way related to, this Agreement . . . .[1]

Parties may also establish in their contracts that their liability will be limited and that this limitation will occur in various ways. For instance, parties may contract that they will only be liable up to a certain amount of damages, for certain kinds of damages, or in the event of a breach. This is a limitation of liability clause, whereby the parties restrict or limit the different ways their liability could attach, which otherwise exists without limitation. A typical provision limiting liability may be found in the "FIDIC's Silver Book," a contract model used across the globe in "EPC/Turnkey Projects":[2]

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[1] *Exclusion of liability Sample Clauses*, LAW INSIDER, https://www.lawinsider.com/clause/exclusion-of-liability/_9 (last visited Feb. 13, 2018).

[2] *See* FÉDÉRATION INTERNATIONALE DES INGÉNIEURS-CONSEILS, CONDITIONS OF CONTRACT FOR EPC/TURNKEY PROJECTS 49 (1st ed. 1999) (ebook).

> 17.6 Limitation of Liability
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> Neither Party shall be liable to the other Party for loss of use of any Works, loss of profit, loss of any contract or for any indirect or consequential loss or damage which may be suffered by the other Party arising out of or in connection with the Contract.
>
> Notwithstanding any other provision of the Contract, Contractor´s liability arising out of or in connection with this Contract shall not exceed -- (--) percent of Contract Price stated in the Contract Agreement.
>
> This Sub-Clause shall not limit liability in any case of fraud, deliberate default or reckless misconduct by the defaulting Party.

In practical terms, it is hard to distinguish a clause limiting liability from a clause completely excluding liability. Usually, this is because exclusion clauses are drafted in a way that "excludes" certain types of causes or damages (e.g., consequential damages or loss of profits). However, the "exclusion" of a certain number of causes or damages is nothing more than a "compression" of the liability; in other words, because the debtor is, in principle, liable for every kind of damage and every kind of cause, except those beyond its control, any provision to the effect of excluding a particular cause or damage is a limitation after all. I would tend to classify the "exclusion of liability" as clauses that eliminate all damages and causes altogether. All the remainder would be classified as "limitations."

On the other hand, parties may set forth in anticipation the amount owed to the creditor in the event of delayed performance or non-performance (as well as defective or even partial performance). There is a variety of clauses of this nature, each performing (jointly or separately) its own contractual function. While some have a mere compulsory role (e.g., incentive function), others have a penalty function, and others may seek to fix the amount of damages (liquidated damages). The following clause functions as a penalty clause:

> Contractual Penalty - For each case of a breach by the Seller or the Seller's Affiliates of obligations set forth in this Section 16, the Seller shall, in addition to any other remedies of the Purchaser under this Agreement or Law, pay to the Purchaser a contractual penalty of EUR ------ (in words: Euro -----). In the event that the Purchaser claims additional damages from the Seller as a result of a breach by the Seller or the Seller's Affiliates, any penalty paid by the Seller pursuant to this Section 16 shall be taken into account when calculating the damage.[3]

The above clause states that the amounts due are classified as a "penalty" (i.e., a monetary obligation), the payment of which arises from a breach of contract, non-compliance, or even a simple delay in the performance of the contract. It is set forth without any regard to the actual damage suffered by the creditor. Its purpose is primarily a "civil punishment," but it may also be a contractual tool to persuade the debtor to comply in a timely manner or otherwise to avoid breaching its contractual obligations.

Nonetheless, the very same wording may be used by parties as a contractual tool to calculate, in anticipation, the amount of damages payable in case of breach, delay, or otherwise non-performance of the contract. In this particular "contractual penalty" clause, it would suffice to have the word "penalty" removed to reveal the compensatory nature of the clause.

The contractual penalty clause illustrates the reason why it is often virtually impossible to distinguish a penalty clause from a "liquidated damages" clause. As it will be explained below in more detail, the difference between these two kinds of clauses lies in the compensatory and the penalty character of the clause. On the grounds of interpretation and operation of a particular clause, one has to ascertain whether the parties wanted to calculate the amount of payable damages in anticipation, or whether to stipulate a contractual fine in the event one or both parties breach or otherwise fail to comply with its contractual obligations. This

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[3] Exclusion of liability Sample Clauses, LAW INSIDER, https://www.lawinsider.com/clause/exclusion-of-liability/_9 (last visited Feb. 13, 2018).

assessment is no different than interpreting every other contractual stipulation, so the subjective (what was the real or presumed intent of the parties) and objective (what did they write or contemplate) elements are put under equal scrutiny.

Be that as it may, on the grounds of general considerations applicable to the limitation and exclusion of liability clauses—and penalty and liquidated damages clauses alike—these contractual features are standard in international contracts, such as international projects and notably large construction projects. To be more precise, the absence of one or more of these clauses in any international contract dealing with large projects is rare.

Indeed, we have long seen since the emergence of these contractual clauses, that are legally and socially relevant in some areas of the economy, that the limitation of liability and liquidation of damages, and other similar clauses, have become a fundamental and standard feature. If we look at licensing contracts, M&A contracts, and construction contracts, to name but a few, we will quickly conclude that virtually every contract provides for these kinds of contractual stipulations. In other words, these kinds of clauses have become fundamental mechanisms of these contracts' types, therefore gaining a status of significant legal relevance.

This idea is especially true for construction contracts, where, in addition to the standard limitation of liability, parties systematically negotiate liquidated damages clauses that allow both parties to agree in advance on the amount of damages that will be payable in case of delay; this avoids the problematic quantification exercise and limits the damages to the agreed amount per day or other period of delay, as well as to an overall amount.

There is an intimate link between these contractual terms—the limitation of liability, liquidated damages, and the like—and the financial terms agreed to in a contract; for example, the higher the risk allocated to the contractor, the higher the price the contractor will expect to receive in compensation for such risks, and vice-versa. In other words, it is important to understand that the negotiated allocation of risk, in which the limitation of liability and liquidated damages play an essential role, is a counterpart for

the price and other conditions agreed to by the parties. By the same token, the limitation of liability and liquidated damages clauses benefit both parties, in that a limitation of liability that is more protective of the contractor will serve the employer by allowing it to enjoy a lower price.

III. PENALTY CLAUSES IN COMPARATIVE LAW

A. Common Law Jurisdictions

The common law has a long-standing tradition of banning penalty clauses. The underlying proposition is that penalty clauses, even if performing a function of deterring breaches of a contract, may entail unjust enrichment and an extravagant or unconscionable quantum of damages.[4] Amounts due under penalty clauses are often higher than the actual damage caused by the debtor. On the other hand, a penalty clause may also be in want of proportionality because it may not weigh the seriousness of the breach: minor and irrelevant breaches of the contract may lead to disproportionate amounts due under that clause. Considerations related to the danger of fraud, oppression, or extortion, as well as the prohibition of double recovery, also play a role in setting aside those kinds of clauses. These considerations are a manifestation of a presumption of unfairness: the disproportion to actual damages induces the conclusion that there must have been fraud, oppression, or mistake when negotiating the compensation provision.[5] In a few words, "For an executory agreement fixing damages in case of breach to be enforceable, it must constitute a reasonable forecast of the provable injury resulting from breach."[6]

There may also be other kinds of interests at stake. As Judge Posner pointed out in *Lake River Corp. v. Carborondum*:

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[4] Robert E. Scott & Charles J. Goetz, *Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach*, 77(4) COLUM. L. REV. 554, 554 (1977), https://doi.org/10.7916/D8ZW1KP2.

[5] *Id.*

[6] *Id.* at 554; *see also* Aristides N. Hatzis, *Having the cake and eating it too: efficient penalty clauses in Common and Civil contract law*, 22 INT'L REV. L. & ECON. 381, 383–402 (2003).

> Penalty clauses provide an earnest of performance. [. . .] On the other side it can be pointed out that by raising the cost of a breach of contract to the contract breaker, a penalty clause increases the risk to his other creditors; increases (what is the same thing and more, because bankruptcy imposes "deadweight" social costs) the risk of bankruptcy; and could amplify the business cycle by increasing the number of bankruptcies in bad times, which is when contracts are most likely to be broken.[7]

This is a rather striking and peculiar way of putting economic considerations on the table when dealing with penalty clauses. Conversely, there are no relevant issues of enforceability if the clause is set forth to reasonably estimate the amount of damages that may arise in the event of a breach of the contract (e.g., a pure liquidated damages clause).

Distinguishing these two kinds of clauses is a matter of law—and not of fact—and where the doubt remains as to its classification, the courts have presumed the clause has a penalty character.[8] However,

> [There] must be a reasonable estimate at the time of contracting of the likely damages from breach, and the need for estimation at that time must be shown by reference to the likely difficulty of measuring the actual damages from a breach of contract after the breach occurs. If damages would be easy to determine then, or if the estimate greatly exceeds a reasonable upper estimate of what the damages are likely to be, it is a penalty.[9]

The current case law and doctrine in the U.S., thus, point out two fundamental criteria to assess whether a particular damage clause has a "penalty" character: (1) the amount must be

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[7] *See* Lake River Corp. v. Carborundum Co., 769 F.2d 1284, 1289 (7th Cir. 1985).

[8] *See id.* at 1290.

[9] *See id*. at 1289-90 (citing M.I.G. Inv. Inc. v. Marsala, 92 Ill. App. 3d 400, 405-06 (1981)).

reasonable in light of the anticipated harm or the actual harm caused by the breach, and (2) the parties could not reasonably calculate or it was otherwise impossible to calculate the presumed loss.[10]

Consistently, section 356, titled Liquidated Damages and Penalties, in the American Restatement of the Law of Contracts provides:

> (1) Damages for breach by either party may be liquidated in the agreement but only at an amount that is reasonable in the light of the anticipated or actual loss caused by the breach and the difficulties of proof of loss. A term fixing unreasonably large liquidated damages is unenforceable on grounds of public policy as a penalty.
> (2) A term in a bond providing for an amount of money as a penalty for non-occurrence of the condition of the bond is unenforceable on grounds of public policy to the extent that the amount exceeds the loss caused by such non-occurrence.[11]

By the same token, section 2-718 of the Uniform Commercial Code ("UCC") states:

> (1) Damages for breach by either party may be liquidated in the agreement but only at an amount which is reasonable in the light of the anticipated or actual harm caused by the breach, the difficulties of proof of loss and the inconvenience or nonfeasibility of otherwise obtaining an adequate remedy. A term fixing unreasonably large liquidated damages is void as a penalty.[12]

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[10] *See* Scott & Goetz, *supra* note 4, at 559; *see also* Aristides N. Hatzis, *Having the cake and eating it too: efficient penalty clauses in Common and Civil contract law,* 22 INT'L REV. L. & ECON. 381, 383–402 (2003). *But see* Banta v. Stamford Motor Co., 89 Conn. 51, 55 (1914) (showing where a court required a third element stating: "there must have been an intent on the part of the parties to liquidate the damages in advance.").

[11] RESTATEMENT (SECOND) OF CONFLICTS OF LAW § 356 (AM. LAW INST. 1988).

[12] U.C.C. § 2-718 (AM. LAW INST. & UNIF. LAW COMM'N).

In a nutshell, the distinction may lie in what the ultimate function of the clause at issue is: if it is designed to grant more than the actual damage, then we face a penalty clause, unenforceable under U.S. law.

The considerations above seem to show that the fundamental principle of the law of contracts in the U.S. is that specific performance should prevail over the compensation, and, if the latter is to be granted, the creditor should only be entitled to "just compensation," equivalent to the value of that performance.

This state of affairs in the U.S. is not substantially different than in the U.K.: "[W]here the Parties to a contract agree that, in the event of a breach, the contract-breaker shall pay to the other a specified sum of money, the sum fixed may be classified by the Courts either as a penalty (which is irrecoverable) or as liquidated damages (which are recoverable)."[13] Like in the U.S., any damages stipulation is considered null and void if the amount is extravagant and unconscionable as compared to the actual damages suffered by the non-breaching party.[14]

The major difference between English and American law is that the former does not require a reasonable estimation of damages but instead a genuine *bona fide* attempt to assess ex-ante the provable losses.[15] However, the English courts have recently developed a new test to distinguish pure liquidated damages clauses (admissible) from penalty clauses. In *Cavendish Square Holding BV v. Makdessi*, the U.K. Supreme Court found a clause to be penal in nature; the clause consisted of "a

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[13] JOSEPH CHITTY, CHITTY ON CONTRACTS 26-109 (H. G. Beale ed., 29th ed. 2004). *See* Yusuf Mohamed Gassim Abeidat, The Penalty Clause in English Law: A critical analysis and comparison with Jordanian Law 12-21 (Jul. 2004) (unpublished Ph.D. dissertation, University of Leeds School of Law) (on file with White Rose eTheses Online) (providing a historical approach and current state of the question). *See* also EWAN MCKENDRICK, CONTRACT LAW 389 (3d ed. 1997).

[14] *See* Clydebank Engineering & Shipbuilding Co. v. Don Jose Ramos Yzquierdo y Castaneda [1905] AC 6 (HL) (appeal taken from Scot.); Dunlop Pneumatic Tyre Co. Ltd. v. New Garage & Motor Co Ltd [1915] AC 79 (HL) (appeal taken from Eng.).

[15] Hatzis, *supra* note 6, at 388.

secondary obligation which imposes a detriment on the contract-breaker out of all proportion to any legitimate interest of the innocent party in the enforcement of the primary obligation."[16]

In other words, the relevant test is not the comparison between the amount set forth as "liquidated damages" and the greatest loss caused by the breaching party, but more precisely the assessment of the "wider interest" of the injured party in having the primary obligation of the contract fulfilled. This means that the critical assessment shifts from an essentially quantitative measure of two lesser evils (the liquidated damages and the actual loss), to a substantially qualitative weighing of the wider legitimate interest of the creditor.[17] It remains to be seen to which extent the weighing of those interests will allow the intervention of considerations related to notions of reasonableness, fairness, and ultimately equity, which play a fundamental role in civil law jurisdictions.

On the opposite side of the globe, Australia seems to have adopted the same shift regarding the assessment of the validity of the "liquidated damages" as opposed to "penalty clauses." In *Paciocco v. Australia & New Zealand Banking Group*, the High Court considered that a clause providing for the payment of a specific amount of money would be enforceable in case of a breach of the contract, provided that such amount is not "out of all proportion to any legitimate interest of the innocent party in the enforcement of the primary obligation."[18] The court considered as "interest," relevant for these purposes, the provisioning of costs in accordance with applicable accounting standards.[19]

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[16] *See* Cavendish Square Holding BV v. Makdessi; ParkingEye Ltd. v. Beavis (Consumers' Association intervening) [2015] UKSC 67 and [2015] 3 W.L.R. 1373 (Eng.).

[17] *See* Peter Godwin, David Gilmore, Emma Kratochvilova, & James Doe, *Landmark decision of English Supreme Court on penalty clauses and enforceability of liquidated damages*, HERBERT SMITH FREEHILLS LEGAL BRIEFINGS (Feb. 29, 2016), https://www.herbertsmithfreehills.com/uk/grads/latest-thinking/landmark-decision-of-english-supreme-court-on-penalty-clauses-and-enforceability-of.

[18] *Paciocco v. Australia & New Zealand Banking Group Limited* [2016] HCA 101, ¶ 319 (Austl.).

[19] *Id.* at 31, ¶ 99.

B. Civil Law Jurisdictions

As will be discussed below, generally speaking, penalty clauses in civil law jurisdictions are admissible, however, they are subject to possible reduction, on the grounds of equity, if found excessive. The admissibility of these clauses is underpinned on the premise that a penalty may play a role of incentivizing the fulfillment of the obligations in a timely and accurate manner, so as to avoid the frustration of the creditor. It is true that these clauses may also play a role in setting forth the amount of damages to be awarded in anticipation of a breach or non-compliance (a liquidation of damages), but whatever function they perform, they should not be set aside merely because they hold a penalty function. In a nutshell, civil law jurisdictions generally allow both penalty and liquidated damages clauses.

12. It is worth noting that this legal framework first developed in France with the enactment of the "Code Civil des Français" of 1804 (the "Code Napoleon" of "Civil Code").[20] To be more precise, the Code Napoleon broke with the principle that every damage stipulation could be reduced or mitigated by the judge if found excessive.[21] The Code Napoleon is a declaration of fundamental personal rights, and started a "codification" movement that influenced almost every country of continental Europe and some of South America (as well as other corners of the world). By consequence, the idea of contractual freedom and the international law principle of *pacta sunt servanda* were erected as paramount principles of the legal system. Hence, it is not surprising that article 1152 of the Code Napoleon sets forth the principle that a penalty clause is untouchable: "When the agreement entails that he who fails in executing the obligation it shall pay a sum on the grounds of damages, there can be allowed to the other party neither a greater nor a lesser sum."[22]

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[20] *See* THILMANY JEAN, *Fonctions et révisibilité des clauses pénales en droit comparé, in* REVUE INT'L DROIT COMPARE 17, 17-54 (Janvier-Mars ed., 1980) (providing a brief historical review).

[21] *See id.* at 19-20.

[22] "Lorsque la convention porte que celui qui manquera de l'exécuter paiera une certaine somme à titre de dommages-intérêst, il ne pourra être alloué à l'autre partie une somme plus forte ni moindre." (Duarte Henriques trans.).

Notwithstanding a number of attempts to mitigate the inflexibility of this principle, grounded in a number of arguments (ranging from the operation of prohibition of abuse of rights, to fraud, and public policy), the Cour de Cassation, France's Supreme Court for Judicial Matters, would stay impermissible to any change on the understanding that a penalty clause is a *pacta sunt servanda*, and should be complied with accordingly. Even article 1231, which states that a "judge may reduce the penalty if the obligation has been partially fulfilled,"[23] could not provide grounds to produce a change in this respect.[24]

However, scholars and commentators had long since pointed out that this rigidity could entail serious abuses and immoral or otherwise gross iniquities, which was in fact happening in various industries, such as the banking industry, where the public interest and consumer rights were put at stake. To follow, article 1152 was amended by Law of 9 July 1975 to allow the judge to mitigate or increase the penalty that has been stipulated, if it is found excessive or derisory; it further states that "any stipulation to the contrary shall be deemed unwritten."[25] The current state of affairs is a result of the "l'Ordonnance du 10 février 2016," which produced a change in many respects. Penalty clauses are now the subject matter of article 1231-5 of the French Civil Code.[26]

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[23] "La peine peut être modifiée par le juge lorsque l'obligation principale a été exécutée en partie." (Duarte Henriques trans.).

[24] *See* THILMANY, *supra* note 20, at 27-28.

[25] [C. CIV.] [CIVIL CODE] art. 1152 (Fr.), http://www.wipo.int/wipolex/en/text.jsp?file_id=450530.

[26] [C. CIV.] [CIVIL CODE] art. 1231-5 (Fr.), http://www.textes.justice.gouv.fr/art_pix/THE-LAW-OF-CONTRACT-2-5-16.pdf ("When the contract stipulates that the person who fails to perform it will pay a certain sum in damages, it cannot be allocated to the other party a greater or lesser sum. Nevertheless, the judge may, even automatically, moderate or increase the penalty so agreed if it is manifestly excessive or derisory. Where the undertaking has been executed in part, the agreed penalty may be reduced by the judge, even ex officio, in proportion to the interest that the partial performance has afforded to the creditor, without prejudice to the application of the previous paragraph. Any stipulation contrary to the two preceding paragraphs is deemed unwritten. Unless final default, the penalty is incurred only when the debtor is in default.").

Roughly speaking, penalty clauses are valid and enforceable, subject to mitigation or a power increase by the judge (who can even do so *ex officio*) if it is found as excessive or derisory. If the obligation has been partially fulfilled, the judge may decide to mitigate the penalty in proportion to the benefits that the creditor has perceived as a consequence of that partial fulfillment. Any stipulation to the contrary shall be deemed null and void.

13. Belgium shared the Code Napoleon root with France, and more particularly the understanding that article 1152 of the French Civil Code provided legal coverage for the validity and enforceability of penalty clauses. However, case law shows that judges were open to entertain that a clause establishing a sum in disproportion to the foreseeable damage ("dommage prévisible") could be considered to violate public policy. If the clause was not stipulated with the aim of anticipating the damage resulting from the breach of the contract, it should be considered as merely "speculative," and therefore null under article 6 of the Civil Code.[27]

Currently, article 1231-5 (in its version resulting from Law 1998-11-23/36) provides that, albeit admissible, a penalty clause may be mitigated by the judge if he considers that the sum provided thereof "manifestly" exceeds the amount that the parties could have initially determined to compensate the breach of the contract. In any event, the judge may not reduce the penalty to an amount lesser than the actual damage, as if that penalty clause had not been included. A reduction is also admissible if the obligation has been fulfilled partially. Any provision to the contrary will be considered null and void.[28]

15. Swiss law also provides for the validity and enforceability of penalty clauses and does so in a manner that couldn't be clearer: the creditor is entitled to the stipulated sum even if he cannot establish that he has suffered damages as a result of the

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[27] *See* Thilmany, *supra* note 20, at 23-24; *see* also Walter de Bondt, *Contracts*, *in* 2 INTRODUCTION TO BELGIAN LAW 222, 241 (Marc Kruithof & Walter De Bondt eds., 2001).

[28] *See* Hof van Beroep [HvB] [Court of Appeal] Antwerpen, June 18, 1996, ALGEMEEN JURIDISCH TIJDSCHRIFT [AJT] 1998, 1993/AR/2933 (Belg.) (upholding the validity of a penalty clause, albeit subject in the particular case to a 50% reduction).

breach of the contract.[29] At the same time, the creditor is not allowed to claim exceeding damages, and the debtor may prove that he is entitled to rescind the contract by paying the full sum of the penalty clause.[30] In any case, the judge may intervene to annul or mitigate the penalty, in the event that this clause has been set forth to sanction an immoral or otherwise illicit obligation, if it is found to be excessive or if the debtor proves that the breach of the contract was not imputable to himself.[31]

Under German Law, the penalty clause is considered valid and enforceable, subject to mitigation if it is found excessive, provided, of course, that the debtor is responsible for the breach or non-compliance.[32] In ascertaining whether a penalty clause is excessive, "every legitimate interest of the obligee, not merely his financial interest, must be taken into account."[33] However, a penalty agreed to be paid by a mercantile trader in the course of his mercantile business is not subject to mitigation under section 340 of the German Civil Code.[34]

In Austria, section 1336 provides that the parties may stipulate to a penalty clause.[35] The judge may mitigate the sum of the penalty if it is found excessive, but the creditor may claim compensation for damages in the amount exceeding that penalty.

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[29] CODE DES OBLIGATIONS [CO] [CODE OF OBLIGATIONS] art. 161(1) (Switz.).

[30] *Id.* art. 160(3).

[31] *Id.* art. 163(2); *see generally* GASPARD COUCHEPIN, LA CLAUSE PÉNALE - ETUDE GÉNÉRALE DE L'INSTITUTION ET DE QUELQUES APPLICATIONS PRATIQUES EN DROIT DE LA CONSTRUCTION (Schulthess Verlag ed., 2008) (providing an overview of this topic under Swiss law).

[32] *See* BÜRGERLICHES GESETZBUCH [BGB] [CIVIL CODE], §§ 339, 343, *translation at* https://www.gesetze-im-internet.de/englisch_bgb/englisch_bgb.html#p1244 (Ger.).

[33] BÜRGERLICHES GESETZBUCH [BGB] [CIVIL CODE], § 343, para. 1, sentence 2, *translation at* https://www.gesetze-im-internet.de/englisch_bgb/englisch_bgb.html#p1244 (Ger.). *See also* Manfred Pieck, *A Study of the Significant Aspects of German Contract Law*, 3(1)(7) ANN. SURV. INT'L & COMP. L. 111 (1996), http://digitalcommons.law.ggu.edu/annlsurvey/vol3/iss1/7.

[34] HANDELSGESETZBUCH [HGB] [COMMERCIAL CODE], § 348, *translation at* https://www.global-regulation.com/translation/germany/387305/commercial-code.html (Ger.).

[35] ALLGEMEINES BÜRGERLICHES GESETZBUCH [ABGB] [CIVIL CODE] § 1336 (Austria).

17. Spanish law, under article 1154 of the Civil Code, provides an example where the penalty clause is not subject to judicial review, even on the grounds of equity, unless the main undertaking has been partially or inaccurately performed by the debtor.[36] Notwithstanding a minority of scholars and commentators advocate that article 1154 does not hamper the judicial mitigation on the grounds of *ex aequo et bono*, the fact is that the superior courts of Spain have consistently and steadily decided that such mitigation is not allowed save for the case of partial or inaccurate performance under the contract.[37]

18. In Portugal, penalty clauses are expressly allowed according to article 810(1) of the Portuguese Civil Code, which states that, "[t]he parties may set forth by agreement the amount of the compensation, so-called penalty clause." Courts and scholars have a long-standing view that the legal regime under article 810 et seq. is more precisely applicable to clauses liquidating damages. Indeed, articles 811(2) and (3) provide that the creditor of a "penalty clause" may not claim exceeding damages (except if otherwise stipulated) and may not claim the payment of the sum foreseen in the clause if it is in excess of the actual damage caused by the breach or partial fulfillment of the contract. This conspicuous legal regime has led the vast majority of the case law and literature to consider it to be applicable to "liquidated damages" clauses only. Thus, pure "penalty clauses" are not subject to these limitations and are enforceable irrespective of the amount provided, except if found excessive (even if this excess is due to supervening circumstances and if the obligation has been partially fulfilled). The reduction will operate according to *ex aequo et bono*.[38]

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[36] C.C., B.O.E. n. 1154, July 24, 1889 (Spain), *translation at* http://www.wipo.int/wipolex/en/text.jsp?file_id=221319#LinkTarget_6412 ("The Judge shall equitably modify the penalty where the principal obligation should have been performed partially or irregularly by the debtor.").

[37] *See* Ignacio Marín García, *Enforcement of Penalty Clauses in Civil and Common Law: A Puzzle to be Solved by the Contracting Parties*, 5(1) EUR. J. LEGAL STUD. 98-123 (2012).

[38] *See* António Pinto Monteiro, *As cláusulas limitativas e de exclusão de responsabilidade sob o olhar da jurisprudência portuguesa recente*, 138(3956) REVISTA DE LEGISLAÇÃO E JURISPRUDÊNCIA 292 (2009). For further developments and elaboration, *see* António Pinto Monteiro *Cláusulas Limitativas e de Exclusão*

Similarly, Brazilian law admits the validity of a "penalty clause," understood as a contractual provision to anticipate the amount of damages owed in case of non-fulfillment of the obligation. Article 408 of the Brazilian Civil Code expressly provides so, but at the same time, Article 412 states that the amount of the penalty may not exceed the value of the principal obligation, subject to reduction if it is found "manifestly excessive" according to the nature and aim of the main contract.[39] The penalty shall also be mitigated by the judge, under article 413, if the obligation has been fulfilled partially.[40] This wording means that the judge is not accorded with the discretionary power to reduce, or not to do so, but instead, he must mitigate the penalty in case of partial performance under the contract.[41]

Article 790 of the Argentine Civil Code sets forth that the "penalty clause" is the one whereby the debtor is submitted to a penalty or fine aiming at guaranteeing the performance under the contract in a timely and accurate manner.[42] In case of delay, the creditor may not claim exceeding damages.[43] The creditor needs not to prove any damage resulting from the delay, and the debtor may not set aside the penalty even if he proves that no harm has been caused. However, the judge may mitigate the amount if it is disproportionate considering the seriousness of the delay, the performance under the contract that may have happened, and every circumstance of the case leading to the conclusion that the creditor would abusively take advantage of that clause.[44] The penalty clause may also provide for "non facere" obligations, and the debtor is not entitled to exempt himself from the main

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de Responsabilidade Civil (1985); António Pinto Monteiro, *Cláusula Penal e Indemnização* (1990).

[39] *See* CÓDIGO CIVIL [C.C.] [CIVIL CODE] arts. 408, 412, 413 (Braz.).

[40] *Id.* art. 413.

[41] *See* SÉRGIO CAVALIERI FILHO, PROGRAMA DE RESPONSABILIDADE CIVIL 316 (10th ed. 2012).

[42] Art. 790, CÓDIGO PROCESAL CIVIL Y COMERCIAL DE LA NACIÓN [CÓD. PROC. CIV. Y COM.], http://www.wipo.int/edocs/lexdocs/laws/es/ar/ar149es.pdf (Arg.).

[43] *Id.* art. 793.

[44] *See id.* art. 794.

obligation by paying the penalty unless he has expressly saved such right.[45]

In Mexico, article 1840 et seq. of the "Codigo Civil Federal" considers a penalty clause to be valid and enforceable.[46] However, the reduction on grounds of *ex aquo et bono* is only admissible if the obligation has been partially fulfilled.

Conversely, in Peru, the penalty clause, albeit enforceable, may be mitigated if found *manifestly excessive* or if the principal obligation has been partially fulfilled (articles 1341 and 1346 of the Peruvian Civil Code). The creditor is not requested to prove his damages but may only claim the payment of the penalty in case of breach or non-performance imputable to the debtor, unless otherwise stipulated (article 1343).

A similar legal regime arises from article 1560 of the Ecuadorian Civil Code ("Código Andrés Bello"), which allows penalty clauses, although it is subject to reduction if the sum stipulated is higher than twice the amount owed under the principal obligation. The debtor is also entitled to a proportional reduction of the penalty in case of partial fulfillment (article 1555). The "Código Andrés Bello" and its legal framework related to penalty clauses are also in force in Chile[47] and Colombia.[48]

IV. PENALTY CLAUSES IN INTERNATIONAL LAW INSTRUMENTS AND GENERAL PRINCIPLES OF LAW

This section will address the issue of penalty clauses in international instruments. I will then move on to look at the international (arbitration) case law dealing with this subject. The aim is to subsequently assess whether or not a general principle of law may be drawn regarding penalty clauses so that, in the

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[45] *Id. arts.* 795, 796; *see* AÍDA KEMELMAJER DE CARLUCCI, LA CLÁUSULA PENAL (1981).

[46] CÓDIGO CIVIL FEDERAL [CC] arts. 1840 et seq., Diario Oficial de la Federación [DOF] 31-08-1928, últimas reformas DOF 28-01-2010 (Mex.), http://www.wipo.int/edocs/lexdocs/laws/es/mx/mx038es.pdf.

[47] CÓDIGO CIVIL DE CHILE [CÓD. CIV.] arts. 1544, 1539.

[48] Código Civil de Colombia [C.C] arts. 1596, 1601.

following section, the issue of possible violation of public policy (and more particularly the international public policy) may be put at stake.

One of the most essential texts in international commerce to seek guidance is the Convention on the International Sale of Goods ("CISG" or "Convention").[49] The common understanding was that the Convention should not specifically and expressly address the validity of penalty clauses, leaving that matter to municipal laws.[50] However, some authors defend that the issue of the validity of penalty clauses should be included within the CISG framework, either by applying the principles of the Convention directly or by interpreting the applicable municipal law according to such principles.[51]

In the meantime, the CISG Advisory Council has issued an "opinion" related to "Agreed Sums Payable upon Breach of an Obligation in CISG Contracts."[52] According to this opinion, the provisions of the Convention also apply to the interpretation and operation of clauses "providing for the payment of agreed sums" due in case of failure to perform under the contract. On the other hand, the Convention does not exclude provisions on the

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[49] United Nations Convention on Contracts for the International Sale of Goods, Apr. 11, 1980, S. TREATY DOC. NO. 98-9, 1489 U.N.T.S. 3 [hereinafter CISG].

[50] *Id.* art. 4 ("This Convention governs only the formation of the contract of sale and the rights and obligations of the seller and the buyer arising from such a contract. In particular, except as otherwise expressly provided in this Convention, it is not concerned with:(a) the validity of the contract or of any of its provisions or of any usage.").

[51] *See* Pascal Hachem, *Fixed Sums in CISG Contracts*, 13 VINDOBONA J. 217, 221-22 (2009), http://www.cisg.law.pace.edu/cisg/biblio/hachem.html (last visited February 20th, 2018); Bruno Zeller, *Penalty Clauses: Are They Governed by the CISG?*, 23 PACE INT'L L. REV. 1 (2011), http://digitalcommons.pace.edu/cgi/viewcontent.cgi?article=1311&context=pilr (last visited February 20th, 2018). *See also* Jack Graves, *Penalty Clauses and the CISG*, SCHOLARLY WORKS (Digital Commons at Touro Law Center, Paper No. 414, 2012), http://digitalcommons.tourolaw.edu/scholarlyworks/414.

[52] CISG-AC Opinion No. 10, *Agreed Sums Payable upon Breach of an Obligation in CISG Contracts*, Rapporteur: Dr. Pascal Hachem, Bär & Karrer AG, Zurich, Switzerland. Adopted by the CISG-AC following its 16th meeting in Wellington, New Zealand on Aug. 3, 2012, http://www.cisg.law.pace.edu/cisg/CISG-AC-op10.html.

"protection of the obligor," and where those provisions call for "notions such as reasonableness, excessiveness or proportionality," consideration must be given to those notions in "accordance with an international standard."[53]

The Principles of European Contract Law are a "set of general rules which are designed to provide maximum flexibility and thus accommodate future development in legal thinking in the field of contract law."[54] Aimed at facilitating cross-border trade within Europe, strengthening the European market, providing guidelines for national courts and legislatures, and creating an infrastructure for community laws, the Principles also have the underlying goal of constructing a bridge between the civil law and the common law.[55] In a nutshell, "these Principles are intended to be applied as general rules of contract law in the European Communities."[56]

Consequently, its provisions related to penalty clauses (emphatically titled as "Agreed Payment for Non-performance") do not differ much from the legal rules deriving from municipal laws of member States:

> (1) Where the contract provides that a party who fails to perform is to pay a specified sum to the aggrieved party for such non-performance, the aggrieved party shall be awarded that sum irrespective of its actual loss.
> (2) However, despite any agreement to the contrary the specified sum may be reduced to a reasonable amount where it is grossly excessive in relation to the loss resulting from the non-performance and the other circumstances.[57]

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[53] *Id.* ¶ 3, 4.

[54] OLE LANDO, PRINCIPLES OF EUROPEAN CONTRACT LAW, PARTS I & II xxvii (Ole Lando & Hugh Beale eds., 2000), https://www.jus.uio.no/lm/eu.contract.principles.parts.1.to.3.2002/.

[55] *See id.*

[56] *Id.* art. 1:101.

[57] *Id.* art. 9:509.

It is worth noting that this wording truly encapsulates the core of the principles applicable to penalty clauses: they are allowed but must be mitigated when found excessive.

In the very same vein, the UNIDROIT Principles of International Commercial Contracts (now in its 2016 version) also provides for clauses related to "agreed payment for non-performance."[58] The UNIDROIT Principles, being one of the international instruments that tribunals most resort to when adjudicating disputes arising out of international transactions, including major infrastructure projects, address the issue of "penalties" almost verbatim from the Principles of European Contract Law (or it is just the other way around . . .):

> (1) Where the contract provides that a party who does not 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 harm.
> (2) However, notwithstanding any agreement to the contrary, the specified sum may be reduced to a reasonable amount where it is grossly excessive in relation to the harm resulting from the non-performance and to the other circumstances."[59]

In some ways, it can be said that the Principles of European Contract Law have merely inked down the so-called *lex mercatoria*. The discussion concerning the existence and the relevance of the *lex mercatoria* is not to be entertained here. Let us just assume its relevance, and at least consider the work that others have done in this field. It is quite remarkable the work that has been done to set up a free online database of transnational principles of commercial law. The results are uploaded at the website "trans-lex.org," which has the mission of compiling the "TransLex-Principles," which is defined as "a systematic online-collection of principles and rules of transnational commercial law, the New Lex Mercatoria. They are being used by counsel and arbitrators in international arbitrations as well as contract

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[58] *See* UNIDROIT PRINCIPLES OF INTERNATIONAL COMMERCIAL CONTRACTS, art. 7.4.13 (2016) https://www.unidroit.org/english/principles/contracts/principles2016/principles2016-e.pdf (last visited Feb. 20, 2018).

[59] *Id.*

drafters, academics, and participants of moot court competitions in international arbitration across the globe."[60]

The penalty clause was not missed therein, albeit dressed as a "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.[61]

V. PENALTY CLAUSES IN INTERNATIONAL ARBITRATION CASE LAW

The focus of this article is the issue of contractual penalty clauses in the context of international arbitration. However, it is surprising to learn that the case law is scarce on this topic. The scarcity of arbitral decisions is indeed a paradox because penalty clauses, at least in civil law jurisdictions, are almost always contracted in all sorts of contracts. The first two cases that I could spot are not a clear-cut example where an arbitral tribunal addressed explicitly the validity and enforceability of penalty clauses.

Thus, in *Laminoirs-Trefileries-Cableries v. Southwire*, where a U.S. Federal District Court did not grant permission to enforce an award that ordered the respondent to pay an additional 5 percent interest if there was a delay in payment.[62] In doing so, the U.S. court judge considered those 5 percent to be a penalty.[63] In the

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[60] *See* https://www.trans-lex.org/principles/of-transnational-law-(lex-mercatoria) (last visited Feb. 20 2018).

[61] *See id.* principle VI.4.

[62] Laminoirs-Trefileries-Cableries de Lens SA *v.* Southwire Co., 484 F. Supp. 1063, 1069 (N.D. Ga. 1980), also reported at (1982) VI *ICCA Yearbook* 247.

[63] *Id.*

ICC Arbitration Case No. 7197 of 1992, the tribunal, applying the CISG and Austrian law, found that the seller had the right to claim compensation notwithstanding a penalty clause that had been inked in the contract.[64]

A second instance is the ICC Case No. 13278 of 2005, where the sole arbitrator upheld a penalty clause provided in a contract for the case of wrongful termination and considered it to be valid and enforceable under Spanish law.[65] At the same time, the sole arbitrator found that the penalty clause at stake would limit the maximum amount of damages to award as a consequence of that termination.[66] This limitation would not have been applied if the obligor had acted willfully and consciously (with "dolus"), which was not proved in that particular case. Further, the sole arbitrator denied the reduction of the penalty clause, which could have been granted if the main obligation had been partially or irregularly performed. In doing so, the sole arbitrator considered that there had been a total lack of performance.[67]

A German author reports an ICC case where a penalty clause was subject to the scrutiny of the arbitral tribunal in the context of the "bargained for in detail" requirement of German law applicable to standard form contracts.[68] It is interesting to note that, in this particular case, "after hearing legal experts on this issue," the tribunal decided that "even though the text of the penalty clause was discussed and changed during the contract

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[64] *See* summary of the case available at http://www.cisg.law.pace.edu/cases/927197i1.html, last accessed on 20 February 2018.

[65] Case no. 13278 of 2005, Award, Yearbook XXXIII 118 (2008).

[66] *Id.*

[67] *See* JEAN-JACQUES ARNALDEZ, YVES DERAINS & DOMINIQUE HASCHER, VI COLLECTION OF ICC ARBITRAL AWARDS 2008-201 95 (2013). Conversely, although rendered in the context of "punitive damages," the ICC Final Award of an arbitral tribunal seated in Switzerland considered that "damages that go beyond compensatory damages . . . constitute punishment of the wrongdoer" and are thus deemed contrary to the public policy of Switzerland. *See also Seller v. Buyer, Final award in Case No. 5946 of 1990,* 16 Y. B. Commercial Arb. 97 (Albert Jan van den Berg ed., 1991).

[68] Klaus Peter Berger, *To what extent should arbitrators respect domestic case law? The German experience regarding the Law on Standard Terms*, 32(2) ARB. INT'L 243–59 (2016), *available at* https://doi.org/10.1093/arbint/aiv006.

negotiations, the clause as a whole was not 'bargained for in detail' and was, therefore, invalid because the amount of the penalty had remained unchanged throughout the contract negotiations."[69]

The last case worth noting is a recent decision of the English High Court that refused to annul an arbitral award that had recognized the validity and enforceability of a penalty clause notwithstanding the fact that those clauses are not admissible in English law (as we have seen above).[70] In this case, a CAS (Court of Arbitration for Sport) arbitral tribunal seated in Switzerland ordered the respondent Pencil Hill Limited to pay the claimant, U.S. Citta di Palermo S.p.A., the amount of € 1.68 million, corresponding to 25% of the € 6.72 million penalty clause inserted in the contract entered into between them.[71] The arbitral tribunal reduced the amount of the penalty clause according to the applicable law (Swiss law). Notwithstanding, the award debtor challenged it before the English courts asserting that any penalty would be in violation of the public policy.[72] Judge Bird refused to set aside the award considering, *inter alia,* that

> [t]here is a strong leaning towards the enforcement of foreign arbitral awards and the circumstances in which the English Court may refuse enforcement are narrow. I am satisfied that the important public policy against enforcement of penalty clauses is not sufficient to permit me to refuse enforcement. The rule does not in my judgment protect a "universal principle of morality." It is not so clearly "injurious to the public good" that enforcement should, without more, be refused. [. . .]

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[69] *Id.*

[70] "In the case [Palermo] fails to pay any of the instalment[s] agreed, then, all the remaining amounts shall become due and as penalty [Palermo] will have to pay an amount equal to the amount pending IE [Palermo] will pay the double of the pending amount at the moment of the fail on the payment." Pencil Hill Limited v. U.S. Citta Di Palermo S.p.A. [2016] (Q.B.) 1, 6, *available at* https://www.kingschambers.com/assets/files/Pencil%20Hill.pdf, last accessed on 20 February 2018.

[71] *Id.* ¶ 8.

[72] *See id.*

> In my judgment the public policy of upholding international arbitral awards, as Walker 1 held in *Omnium*, outweighs the public policy of refusing to enforce penalty clauses. The scales are tipped heavily in favour of enforcement.[73]

VI. PENALTY CLAUSES AND A GENERAL PRINCIPLE OF LAW

In the endeavor to assess whether there is a general principle of law related to penalty clauses, I do not intend to lay down any new comparative method, nor elaborate on a specific method. That task by itself would be the subject matter of separate and certainly more extensive work. The scope and nature of this article only allow me to provide a perfunctory analysis and gather a few thoughts on the topic. In any case, given that this article is aimed at the arbitration realm primarily, I will follow Fouchard, Gaillard, and Goldman's underlying guidance:

> In order to be considered as a general principle, a rule need not be found in every legal system [. . .] whereas the goal is precisely to find a generally accepted tendency rather than to select, often somewhat randomly, a particular legal system to govern disputes.[74]

From the outset, there is a distinction to be made: the questions arising from penalty clauses in international arbitration do not equate to those entertained by the power of arbitral tribunals to award "punitive damages," nor do they assimilate to the question of whether arbitral tribunals are empowered to impose penalties and sanctions to parties and counsel.

Indeed, a penalty clause may in some ways resemble *punitive damages*. After all, they perform an ultimate common function of sanctioning and punishing someone's wrongdoing. However, each of them rely on different requisites: while punitive damages may generally be awarded—when available according to the

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[73] *Id.* ¶¶ 30, 32.

[74] FOUCHARD, GAILLARD, & GOLDMAN ON INTERNATIONAL COMMERCIAL ARBITRATION 1458 (Emmanuel Gaillard and John Savage eds., The Hague: Kluwer Law International, 1999).

proper law—as a sanction to "malicious, oppressive, fraudulent, willful, reckless, wantonly indifferent, or opprobrious" conduct, the operation of a penalty clause is satisfied with the breach or defective performance under the contract. [75] At the same time, the power of arbitral tribunals to award punitive damages is disputed both on grounds of "arbitrability" and public policy, while penalty clauses may generally operate if not found excessive.[76]

Another similar question relates to *penalties* and *sanctions* imposed by both state courts and arbitral tribunals on parties and their counsels. Albeit subject to considerable controversy regarding whether arbitral tribunals enjoy the power of ordering these kinds of sanctions,[77] there is no question that they may only arise in the context of a pending proceeding. They are a consequence of a procedural (mis)behavior.[78] In sum, those sanctions are procedural tools and not remedies arising out of a contract.

Coming back to Fouchard, Gaillard, and Goldman's guidance, I would submit that there is more than a mere "general accepted tendency" regarding the issue of penalty clauses. Indeed, it is possible to draw a double-faced principle of law in this respect. This double-faced principle lives on the very edge of two conflicting forces of the contract law arena. On the one hand, there is no question that the parties enjoy the right of contractual freedom to its fullest extension, which is protected by the basic rule of *pacta sunt servanda*. On the other hand, there is also an overarching principle of law that every right cannot be exercised

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[75] *See* Marilyn K. Minzer, Jerome H. Nates, Clark D. Kimball, Diane T. Axelrod, & Richard P. Goldstein, *Damages in Tort Actions* § 40.11 at 8 (1962), *cited* by Karen J. Tolson, *Conflicts Presented by Arbitral Awards of Punitive Damages*, 4(3) ARB. INT'L 255–65 (1988), *available at* https://doi.org/10.1093/arbitration.

[76] *See* E. Allan Farnsworth, *Punitive Damages in Arbitration*, 7(1) ARB. INT'L 3–16 (1991), *available at* https://doi.org/10.1093/arbitration/7.1.3.

[77] *See* Abba Kolo, *Witness Intimidation, Tampering and Other Related Abuses of Process in Investment Arbitration: Possible Remedies Available to the Arbitral Tribunal*, 26(1) ARB. INT'L 43, 58 (2010), *available at* https://doi.org/10.1093/arbitration/26.1.43.

[78] *See* 3 GARY BORN, INTERNATIONAL COMMERCIAL ARBITRATION 3083 (2d ed., 2014).

in abuse, which is covered by the principle of good faith.[79] Every right must be exercised in good faith, without any abuse and free from excesses.

The comparative snapshot provided above shows that, concerning the issue of penalty clauses, there is a "tronc commun," or common theme. As we have seen, civil law jurisdictions generally accord the fullest possible protection to contractual freedom subject to limitations deriving from excess.[80] Therein, contractual freedom leads to admit any clause and, thus, clauses providing for a penalty should the obligor fail to comply are admissible (the rule), save where excess occurs (the exception).

Conversely, in common law jurisdictions, clauses fixing the amount due in case of non-performance or otherwise breach or termination of the contract are considered to be a penalty and, therefore, are deemed against public policy (the rule), except if they constitute a "bona fide" attempt to reasonably calculate that amount (the exception).

If we consider that a penalty clause performs a fundamental role of fixing, in anticipation, the amount of damages to award or, likewise, if we consider that a clause that sets forth the amount due in case of non-performance (but admits no evidence that the creditor has suffered damages in a lesser degree of that which was stipulated), also performs a "punitive" role, then we are merely speaking in an euphemistic way and using different words to express the same reality. If that is the case—and I think it is indeed—then we are dealing with two sides of the same coin.

Either on the grounds of the rule or the exception, penalty clauses (or liquidated damages clauses) are admitted as a matter of general principle of law. Either on the grounds of a limit to the excess or a requisite to its validity, the absence of "unreasonableness" in fixing the amount is also a principle to require for the validity and enforceability of a clause.

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[79] *See generally,* Duarte G. Henriques, *Pathological arbitration clauses, good faith and the protection of legitimate expectations*, 31(2) ARB. INT'L 349-62 (2015); Duarte G. Henriques, *The role of good faith in arbitration: are arbitrators and arbitral institutions bound to act in good faith?*, 33 ASA BULLETIN 514 (2015).

[80] And other limitations in consideration of the public interest involved, such as those deriving from illicit, immoral, or otherwise illegal provisions.

In this regard, speaking about "reasonableness," "absence of excess," and "bona fide attempt to fix the amount" is all but different words to convey the same notion. I would nevertheless submit that every possible word could be conjured only to find an ultimate principle of "proportionality," this time formulated more positively. In such a context, the notion that the penalty may also be reduced or mitigated in case of partial fulfillment, which surfaces in a number of jurisdictions, is also reconcilable with the notion of "proportionality." In other words, a penalty would be "out of proportion" if the partial performance under the contract would not be taken into account.

Fouchard, Gaillard, and Goldman put it in a slightly different dimension but convey the same rationale:

> However, in cases where the contract does stipulate that the arbitrators may make an award of damages exceeding the value of the actual loss, it is possible for them to apply a principle, based on comparative law, whereby the effects of excessive penalty clauses should be tempered. The precise remedy varies in different legal systems, but reducing the effects of penalty clauses (rather than holding such clauses void altogether) would be more in keeping with the spirit of international commercial law, particularly in cases where the parties have submitted their disputes to general principles of law or remained silent as to the applicable law.[81]

In sum, I believe that there is a general principle of law that may be drawn in respect of penalty clauses: subject to a principle of proportionality, penalty clauses are allowed in international commercial law.

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[81] *See* FOUCHARD, GAILLARD, GOLDMAN ON INTERNATIONAL COMMERCIAL ARBITRATION (Emmanuel Gaillard & John Savage eds., The Hague: Kluwer Law International, 1999); Charles Calleros, *Punitive Damages, Liquidated Damages, and Clauses Penales in Contract Actions: A Comparative Analysis of the American Common Law and the French Civil Code*, 32(1) BROOK. J. INT'L L. 67-119 (2006).

[81] *See* Pencil Hill Limited v. U.S. Citta Di Palermo S.p.A. [2016] (Q.B.) 1, 6, *available at* https://www.kingschambers.com/assets/files/Pencil%20Hill.pdf, last accessed on 20 February 2018.

VII. PENALTY CLAUSES AND PUBLIC POLICY

The question that now follows is to ascertain the fate of a penalty clause that might have been upheld by arbitral tribunals notwithstanding its disproportionality. We have seen that an English court refused to annul an arbitral award upholding a penalty clause. It was considered that, albeit in a possible contradiction to public policy, the *favor arbitrandi* of the New York Convention justified the refusal to set aside that award.[82] As eloquently put by Judge Bird, the scales were "tipped heavily in favour of enforcement."[83]

The question seems to be pertinent because the public policy exception is accepted, virtually across the globe, as one of the few grounds that allow state courts to refuse the recognition and enforcement of foreign arbitral awards. According to article V of the New York Convention:

> (2) Recognition and enforcement of an arbitral award may also be refused if the competent authority in the country where recognition and enforcement is sought finds that: (b) The recognition or enforcement of the award would be contrary to the public policy of that country.[84]

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[82] *See* Pencil Hill Limited v. U.S. Citta Di Palermo S.p.A. [2016] (Q.B.) 1, 6 ¶ 37, *available at* https://www.kingschambers.com/assets/files/Pencil%20Hill.pdf, last accessed on 20 February 2018.

[83] *Id.* ¶ 32. *Contra* Portuguese Supreme Court of Justice of 14 March 2017, Ref. 103/13.1 YRLSB.S1, www.dgsi.pt. In that case, the "excess" was found not in the clause itself, but on the outcome that it produced in the particular case. This decision could be criticized based on the fact consideration was given only to the disproportion between the amount of the "penalty" and the time that the obligor had to undertake to pay it (25 years of his entire yearly salary), but not to the disproportion toward the amount with the actual damage that might or was indeed caused. *See* KLUWER ARBITRATION BLOG (July 4, 2017), http://arbitrationblog.kluwerarbitration.com/2017/07/04/international-public-policy-portuguese-state-matter-value/. Conversely, in a decision issued on Nov. 29, 2007, the Lisbon Court of Appeal considered that an arbitral award ordering the respondent to pay the claimant an amount arising from a contractual ''penalty clause'' was not in violation of the international public policy of the Portuguese State. DECISÕES DO TRIBUNAL DA RELAÇÃO DE LISBOA (Feb. 20, 2018), www.dgsi.pt.

[84] Convention on the Recognition and Enforcement of Foreign Arbitral Awards, June 10, 1958, Art. V [hereinafter New York Convention].

This provision is replicated, with more or fewer differences in the drafting, in virtually every national legislation applicable to arbitration. Further, the public policy exception may be found in national statutes applicable to the recognition and enforcement of foreign court decisions. A point where national laws may differ among themselves is where they consider the *international public policy*, and not only the mere "public policy," as grounds to refuse recognition and enforcement of foreign arbitral awards. I will come back to this distinction below.

The above New York Convention provision gives a hint that no exact or fixed solution may be found to this question. In fact, by referring to a power, rather than to a duty of a court judge ("may also be refused"), the drafters of the New York Convention left the door intentionally open to different outcomes in light of various factual backgrounds. Thus, we cannot but lay down some general considerations related to the issue of public policy and ascertain whether those considerations lead to a final and decisive test or, to the contrary, simply provide a tool to assess every particular case. It is, therefore, worth noting some thoughts on the topic, as will be seen below.

Neither national courts nor international decision-making bodies have produced a final definition or classification of cases fitting in the concept of "public policy." Notwithstanding the lack of a clear-cut definition of "public policy" (both domestically and internationally), we may find in the Final ILA Report on Public Policy ("Report")[85] a remarkable instrument to guide the analysis of these concepts and a useful tool to draw a roadmap. The Report also provides us with a list of situations equating to the various forms of "public policy," as classified therein.

Indeed, the Report indicates the following definition of "international public policy" (*Recommendation* 1*(c)*):

> [T]he body of principles and rules recognised by a State, which, by their nature, may bar the recognition or enforcement of an arbitral award rendered in the

[85] *See* Pierre Mayer & Audley Sheppard, *Final ILA Report on Public Policy as a Bar to Enforcement of International Arbitral Awards,* 199(2) ARB. INT'L 249-63 (2003).

> context of international commercial arbitration when recognition or enforcement of said award would entail their violation on account either of the procedure pursuant to which it was rendered (procedural international public policy) or of its contents (substantive international public policy).[86]

The Report further concludes (*Recommendation 1(d)*) that

> [T]he international public policy of any State includes: (i) fundamental principles, pertaining to justice or morality, that the State wishes to protect even when it is not directly concerned; (ii) rules designed to serve the essential political, social or economic interests of the State, these being known as "*lois de police*" or "public policy rules"; and (iii) the duty of the State to respect its obligations towards other States or international organizations.[87]

The Report concludes that it is possible to point out three categories—fundamental principles*, lois de police,* and international obligations—and the corresponding examples. As examples of substantive fundamental principles, the Report enumerates (although not exhaustively) the prohibition of abuse of rights, the obligation to act in good faith, the *pacta sunt servanda*, the prohibition against uncompensated expropriation, the prohibition against discrimination, the ban on activities that are *contra bonos mores*, and the proscription against piracy, terrorism, genocide, slavery, smuggling, drug trafficking, and pedophilia.[88] Regarding procedural public policy principles, the Report exemplifies the following: impartiality; prohibition of inducement; fraud or corruption when making the award; prohibition of breach of the rules of natural justice; obligation to treat the parties equally when appointing the arbitrators; respect for due process; respect for consistency with other courts'

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[86] *Id.* at 253.

[87] *Id.* at 255.

[88] *Id.* at 256.

decisions and respect for the *res judicata* effect; and prohibition of manifest disregard for the law or for the facts.[89]

In respect of the "public policy rules" (*lois de police*), the Report points to the anti-trust law and also currency controls, price fixing rules, environmental protection laws, measures of embargo, blockade or boycott, tax laws, and laws to protect parties presumed to be in an inferior bargaining position (e.g. consumer protection laws).[90] The United Nations' resolutions imposing sanctions are given as an example of an international obligation equating to international public policy.[91]

We may now proceed, having the preceding landscape in mind. When it comes to asserting the existence of a fundamental principle encompassed by the notion of "international public policy," and, more particularly, when affirming whether a national rule of mandatory nature is part of that public policy, one must bear in mind that some mandatory provisions are decidedly part of that international public policy, but that others are not.

When assessing this issue, it is necessary to first simulate the outcome of the application of a foreign rule or decision anchored in that rule. In fact, one needs to ascertain if the result of the use of a foreign rule contends with the basic principles and values of a given State. Particularly in the case of the recognition of a foreign decision (whether judicial or arbitral), it is necessary to ascertain whether the application of the legal rule in which the decision is anchored contends with those principles and values. The same applies when the foreign decision has omitted the use of a legal rule of the State of recognition, even if this rule is of a mandatory nature (and even if it may be considered to be part of the "domestic public policy"). If the "simulation" produces a negative result, the recognition and enforcement of a foreign decision may not be refused.

The international private law (the system of conflict of laws rules) relies on the recognition of a diversity of legal solutions for

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[89] *Id.*

[90] *Id.*

[91] *Id.* at 255-56.

a particular case in the transnational context. That is, every State admitting the relevance of a foreign legal rule presumes that a solution to a particular case resulting from the application of that foreign rule may differ from the solution given by the national law of that State. The same is true in relation to the "circulation" of foreign decisions (either judicial or arbitral): in principle (and mostly within countries bound by international conventions such as the New York Convention), each State shall recognize a decision made in another country, even if that decision applies a foreign rule contrary to any domestic rule, irrespective of its mandatory nature (or does not apply a national rule purported to be mandatory).

This diversity shall only be refused recognition when such recognition collides with those fundamental principles and values that the local community may not waive when confronted with foreign rules or decisions.

I will now to turn to the distinction between "international public policy" and the (let us call it) simple "public policy." I have referred indistinctively about these two notions, and this may have produced some muddle. However, it was done on purpose as a way to elicit the following idea.

International public policy is narrower than the notion of "public policy." In some ways, it may be said that international public policy is a "depuration" of that broader concept of "public policy." It consists of a host of economic, social, and political values that society may not waive when and where that society interacts with the other societies (or more precisely, when and where the values of a particular nation interact with the values of other nations). It is a core of principles regulating the action of a particular state in the "Concert of Nations." In this context, it may be said that the international public policy is a door that is closed to legal solutions (be it in the form of foreign decisions or foreign law applied by local courts or arbitral tribunals) coming from other countries, because their fundamental values in the "Concert of Nations" would be otherwise defrauded. In such a circumstance, the State must not waive its right to set aside a foreign decision (or rule) that produces a result shockingly violating those values.

Now, turning to the final question, can it be postulated that penalty clauses violate the international public policy or even the public policy of a given state? We already have all the necessary tools to answer that question; all we need is to ascertain whether or not the contractual freedom in any given state is a fundamental value in the "Concert of Nations" for that state, and whether or not the lack of "proportionality" of a particular clause entails a violation of the values underpinning the presence of that state in such a "Concert."

This conclusion applies, of course, in regard to the international public policy, when and where only such a notion allows the refusal of recognition and enforcement of foreign decisions (or the application of foreign legal rules). By the same token, if that particular state allows or even obliges the court judge not to recognize a foreign decision (or to apply a foreign rule) on the grounds of violation of its "public policy," then all we need to know is whether the aforementioned values are part of the fundamental principles of that particular state, irrespective of its impact on its presence on the "Concert of Nations."