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Contract Management

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For the Industrial Plant Business

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Mediation: A Useful Alternative?

Formal dispute resolution can be costly, stressful and time consuming. Contract managers and lawyers are constantly seeking out new or alternative methods of dispute resolution more suitable for parties longer term needs. The most popular alternative developed in recent times is mediation. How useful is it?

Traditional v
Alternative
Dispute
Resolution

Most forms of contract will contain a clause explaining what is to be done in the case of a dispute between the parties. In recent years, much criticism has been levied at “traditional” dispute resolution methods and “alternative” methods have grown in popularity. The traditional routes of litigation and arbitration have been particularly eclipsed by the growing interest in and use of mediation. In this article, the traditional routes are contrasted with mediation to highlight the advantages and disadvantages.

Litigation

Litigation arises when a party seeks the resolution of a dispute in the public court system under the relevant court proceedings. There are certain advantages to litigation. In most countries the courts are a system with well-established rules of procedure and principles that have withstood the test of times. There are low “procedural” costs since court facilities and judges are often provided at public expense. There are no joinder difficulties in litigation: Courts usually have the power to join additional parties (e.g., subcontractors) in a consolidated action. Parties may prefer to have court judges deal with difficult legal issues rather than arbitrators. In addition, in certain jurisdictions, notably the US, parties may prefer juries to evaluate fact issues and to take “gut decisions”. It may be easier to appeal to a jury on the basis of fairness and reasonableness (“average man in the street argument”).

There are also many disadvantages to litigation. Because of complex rules and procedures, cases can take a long time and consequently cost a great deal of money in terms of expenditure on lawyers and witnesses. In some countries, court cases can go on for years and parties can be the victims of institutionalised corruption.

Arbitration

Arbitration is usually no more and no less than litigation in the private sector. The arbitrator is called upon to find the facts, apply the law and grant relief to one or other or both of the parties." So said Sir John Donaldson M.R. in the landmark English case of Northern Regional Health Authority v. Derek Crouch [1984] Q.B. 644 at 670 (C.A.) and it remains the perhaps best description.

Many international contracts contain an arbitration agreement stating that disputes are to be referred to arbitration, normally in accordance with the rules of one of the international institutions that administer arbitral proceedings such as the International Chamber of Commerce.

Arbitration has many advantages. The parties are free to choose an arbitrator experienced in the industry. Arbitration is very flexible. Parties are free to tailor the procedure, the form and level of representation in accordance with the individual contract. For example parties can:

- Choose extent of discovery.
- Choose location and time of arbitration.
- Choose law and procedure (ICC, AAA, etc.).

Other Advantages of arbitration:

- Expedition: More influence on speed of proceedings.
- Privacy: Arbitration proceedings are not open to the public or the press. Awards usually remain confidential.
- Finality: Usually no appeal (though this may also be a disadvantage if the arbitrators get it seriously wrong).
- Worldwide enforcement: Courts of most countries will enforce the arbitration agreement and prevent any court proceeding.
- Recognition and enforcement of arbitration awards in the international setting is usually considerably easier due to the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards of 1958.

Mediation

Mediation is a voluntary, non-binding, without prejudice, private dispute resolution process in which a neutral person helps the parties try to reach a negotiated settlement. It is possible to distinguish between facilitative mediation, where the mediator aids or assists the parties' own efforts to formulate a settlement; and evaluative mediation where the mediator additionally helps the parties by introducing a third-party view over the merits of the case or of particular issues between the parties.

The mediation process often last only one or two days. The mediator receives written statements before hand. He then meets with the parties,

individually and later together as he sees fit. The procedure is largely informal and solution centred..

Mediation with Conciliation

Sometimes refers to a process similar to mediation but in which the third party takes a more activist role in putting forward terms of settlement or an opinion on the case. However, there is no international consistency over which term is regarded as the more activist and 'mediation' is increasingly being adopted as the generic term for third-party facilitation in commercial disputes.

Mediation With Executive Tribunal or Mini-trial

A process, sometimes called 'mini-trial', in which parties make formal but abbreviated presentations of their best legal case to a panel of senior executives from each party, usually with a mediator or expert as neutral chairperson. Following the presentations, the executives meet (with or without the mediator or expert) to negotiate a settlement on the basis of what they have heard.

Advantages of Mediation

Mediation offers a range of benefits over litigation and arbitration:

Speed

Mediation processes can be set up as quickly as the parties wish, and usually only last a day or two except in more complex cases.

Cost-effectiveness

Because of its speed and focusing of negotiations, mediation saves in legal costs and management time.

Confidentiality

Mediation processes are private and 'without prejudice' - meaning that discussions and offers to settle cannot be repeated after the event if litigation follows. They are also confidential, avoiding any unwanted publicity and minimising the "reputation" risk.

Control

The parties remain in control of a mediation process and any settlement agreed. They retain their legal rights if no agreement is reached. There is none of the risk or stress associated with the imposed decisions of litigation and arbitration, nor the sense of being a passive observer of a formal process.

Commercial

Mediation can generate solutions that meet the parties' commercial or personal interest and future needs, rather than focusing only on past legal rights and wrongs. Flexible settlements can be reached, taking into account non-monetary solutions such as apologies, explanations, changes in practice, re-negotiated contracts etc.

Business-relationships

Mediation processes are significantly closer to business negotiations than adversarial courtroom procedures, so business relationships can be better preserved or extended.

In Summary

There are however some major disadvantages to mediation. There needs to be a genuine desire on both sides to reach a settlement otherwise

mediation will not work. Unlike arbitration, which compels parties to prepare claims and defences with the certain knowledge that a trained arbitrator will adjudicate on their merits, mediation has no such motivation. The process could therefore be abused, perhaps by a party stalling for time or for the purposes of fishing out the other party's claim and settlement position. In short, in many cases it might be better for a party to have its "day in court".

There is also something unsettling about the new industry of consultants and companies offering mediation management that has recently developed. Many of the new practitioners are ex litigation lawyers who promote mediation with almost evangelical zeal, indeed with the same glassy eyed certainty that Saul (St Paul) must have shown after his trip to Damascus.

Mediation has its place, but it is not suitable for all disputes, therefore this writer cannot recommend that it be included in a contract as the principal means for resolving disputes. Better that it remains an alternative to arbitration.

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Liquidated Damages v Penalties

Industrial plant contracts often contain pre-agreed compensation for breaches of contract in the form of liquidated damages or penalties, mainly for delay or failure to reach performance guarantee levels. The two terms “liquidated damages” and “penalties” often cause confusion. Much of the confusion is language based with both terms used interchangeably. However, there is a difference, which falls across the boundary between the two main legal systems, the common law and civil law jurisdictions.

The Common Law Approach

In the United States a liquidated damage clause is intended to estimate damages in the event of non-performance or breach of contract. A liquidated damages clause will be enforced where the court finds that the harm caused by the breach is difficult to estimate, but where the amount of liquidated damages is reasonable compensation and not disproportionate to the actual or anticipated damage. The intent of liquidated damages is simply to measure damages that are hard to prove once incurred. If the liquidated damages are disproportionate, they can however be declared a penalty. The clause is then void, and recovery will be limited to the actual damage that results from the breach.

The treatment of liquidated damage clauses varies slightly among different jurisdictions within the US, but generally there are two elements the courts consider to determine whether a liquidated damage clause is enforceable. The first is the uncertainty element; whether the harm caused by the breach is difficult to calculate. The second element is whether the amount of the liquidated damages is reasonable in proportion to the actual or anticipated harm. If it is not, then it is a penalty, which is against public policy and therefore the clause is unenforceable.

The American approach to liquidated damages can be illustrated by both the Uniform Commercial Code and the Restatement 2d Contracts:

Restatement 2d Contracts § 356:

(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.

UCC § 2-718:

(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.

Most other common law countries such as England, Australia, Ireland and Canada have similar rules with regard to liquidated damages, and do not allow for liquidated damages that are used as a penalty.¹ One exception to the rule is India, where the Contracts Act makes no distinction between liquidated damages and penalties, and allows for contractual damages for failure to perform even if the intention is to penalize.²

It is significantly more difficult to find a consistent application of the concept of liquidated damages or other contractual “penalties” in civil code countries in the international marketplace. The UN Convention on Contracts for the International Sale of Goods (CISG), which has generally been an important tool in developing a more uniform international sales law, regulates neither liquidated damages nor penalty clauses. In fact, the framers of the CISG agreed to leave these clauses out of the convention, in favor of regulation by domestic law, due to widely divergent approaches in different legal systems³. The enforceability of liquidated damage and penalty clauses thereby depends on domestic law.

¹ See, for example, one of the leading cases on penalties, *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd* [1915] AC 79, 86-87, where the House of Lords established the principles on how to determine whether a damage clause actually is a penalty and thereby unenforceable. This case was cited by the High Court of Australia in *Ringrow Pty Ltd v BP Australia Pty Ltd* [2005] HCA 71, section 12, and by the Supreme Court of Ireland in *O'Donnell v Truck and Machinery Sales Limited* 1998 4 IR 191. The Supreme Court of Canada has adapted a similar approach in *Elsley v. J.G. Collins Ins Agencies*, [1978] 2 S.C.R. 916, 946 and does not allow for any recovery of an amount exceeding the actual damage.

² Indian Contracts Act , Section 74

³ Marcus S Jacobs & Yanming Huang, *An Arbitrator's Power and Duties Under Art 114 of Chinese Contract Law In Awarding Damages in China In Respect of A Dispute Under Contract Governed by CISG*, *Mealey's International Arbitration Report* (May 2005, Volume 28, Issue #5) at 3.2

One dilemma in the comparison between common and civil law is the confusion of terminology with regard to liquidated damages. This confusion arises because in some countries, whether under civil code or doctrine or case law, both concepts are recognized and the terms are used interchangeably.

In the UNICITRAL uniform rules relating to liquidated damages and penalty clauses, this problem has been solved by simply referring to both as “contract clauses for an agreed sum due upon failure of performance”.⁴ According to the UNCITRAL rules, an agreement between parties of a contract to pay a certain sum in the event of non-performance is generally allowed, whether as a penalty or compensation. However, the amount can be reduced by the courts if it is “substantially disproportionate to the actual loss”.⁵

Liquidated Damages and Penalty Clauses in Civil Codes

In civil law countries, the attitude towards contractual penalties is quite different from the common law approach. The Napoleonic Code, upon which most civil codes are based, allowed for penalties to encourage performance of contractual obligations. (This is the precise rationale that is rejected in the U.S.) In recent years, however, there has been a widespread trend in civil law countries toward narrowing the scope of such penalties, and allowing courts to reduce the amount if they find it excessive.

Traditionally, in civil code countries, there was no distinction between liquidated damages clauses and penalty clauses.⁶ Recently, a more common approach seems to distinguish between liquidated damages clauses that are used to estimate damages in case of non-performance based on the concept that there has been an actual harm to the plaintiff, and penalty clauses that are used to establish a penalty to be paid in case of non-performance with the intent to encourage performance. The latter does not require proof of any real damage.

Penalty clauses in civil law jurisdictions can be described as the kind of liquidated damages that would not be enforceable in the U.S. due to public policy prohibiting liquidated damages designed to punish the non-performer. Although penalty clauses have been generally enforceable in civil law countries, they can now be mitigated by the court in most jurisdictions⁷. The Council of Europe issued a “Resolution on Penalty

⁴ *Uniform Rules on Contract Clauses for an Agreed Sum Due upon Failure of Performance and Draft United Nations Convention on Contract Clauses for an Agreed Sum Due upon Failure of Performance*. Official Records of the General Assembly, Thirty-eighth Session, Supplement No 17 (A/38/17, annexes 1 and 2).

⁵ *Id.* article 9

⁶ Antonio Pinto Monteiro, *Clause Penale/Penalty Clause/ Verstagsstrafe*, *European Review Private Law* 1:149-155, 2001 (Kluwer Law International.) at 149

⁷ Scottish Law Commission, *Penalty Clauses*, (Scot Law Com No 171) 1999, at 2-3

Clauses” in 1971, with the aim of recommending a uniform application of penalty clauses for the member states to use. The resolution allows penalty clauses, but the penalty amount may be reduced by the courts if they are manifestly excessive, or if part of the main contractual obligation of the contract has been performed⁸.

The explanatory memorandum to the Resolution provides a list of factors in determining whether a penalty is manifestly excessive. They include the comparison of the pre-estimated damages to the actual harm; the legitimate interest of the parties, including non-pecuniary interests of the promisee; what category of contract it is and under what circumstances it was concluded, with emphasis on the relative social and economic position of the parties; whether it was a standard form contract; and whether the breach was in good or bad faith.⁹

Many, but not all, civil codes seem to have followed the precedent of the Resolution to allow courts to reduce an excessive penalty, as demonstrated by the following examples:

France: Articles 1226 to 1233 of La Code Civil regulates “la clause pénale” (penalty clause), and article 1152 regulates “dommages-intérêts” (liquidated damages). The former may be reduced by a judge if part of the main contract obligation has been performed and if it is “manifestly excessive”. Liquidated damages may also be adjusted if “obviously excessive or ridiculously low”.¹⁰

Italy: Both concepts, “clausola penale” (penalty clause) and “liquidazione convenzionale del danno” (liquidated damages), exist in doctrine, but not in the Civil Code.¹¹ Penalties are generally enforceable but can be mitigated if “manifestly excessive” or if part of the main contract obligation has been performed.^{12, 13}

Spain: Article 1154 of the Codigo Civil regulates penalty clauses (Clausula Penal), which can be reduced by a judge if part of the main contract obligation has been performed. There is no provision regarding mitigation of the penalty because of excessiveness, which makes Spain one of the few countries that has not amended its Civil Code to allow a reduction of a penalty amount.

⁸ Resolution 78 (3) of the Committee of Ministers of the Council of Europe; *Relating to Penal Clauses in Civil Law*

⁹ Larry A. DiMatteo, *A Theory of Efficient Penalty: Eliminating the Law of Liquidated Damages* 38, Am. Bus.

L.J. 633, at 653

¹⁰ Article 1152 of Code Civil

¹¹ Article 1382 in Codice Civile regulates penalty clauses.

¹² Id. article 1184

¹³ The Portuguese Codigo Civil takes an identical approach in its article 812.

Germany: There is a distinction between liquidated damages (*Schadenspauschale*) and contractual penalties (*Vertragsstrafe*) in the German Civil Code, and both are allowed according to article 340 and 341 of the BGB. The difference between them is that the latter can be mitigated if “disproportionate or excessively high”.¹⁴

Netherlands/Switzerland: Both these countries have rules similar to Germany except that a penalty may be mitigated in the Netherlands if “manifestly excessive”, and in Switzerland if “excessive”.¹⁵

Belgium: Penalty clauses are permitted, but the amount can be mitigated if it “obviously exceeds the actual damage”, and if part of the main contract obligation has been performed.¹⁶

Scandinavia: The laws of Denmark, Finland, Norway and Sweden allow either the voiding or reformation of a penalty clause that is deemed to be “unreasonable”. Swedish law specifically provides for an evaluation of the relative bargaining power of the parties in making this determination. The Swedish Commercial Code Section 36(2) provides that “particular consideration” shall be given to protecting the party “in a subordinate position in the contractual relationship.”¹⁷

Other civil law countries outside Europe have adopted a similar approach, such as:

China: Penalty clauses in contracts are permitted, according to article 114 of the Chinese Contract Law. The amount can be increased or reduced by the People’s Court or in arbitration if “excessively higher than loss”.¹⁸

Russia: The New Civil Code from 1994 allows for both liquidated damages and contractual penalties in contracts. Both can be reduced by the court if obviously disproportionate to the actual loss.¹⁹

Application in the Courts of Civil Law Jurisdictions

It is difficult to find any uniform application of liquidated damages/penalty clauses in case law of the various European countries. In most countries the courts never evaluate the intent behind the penalty. Whether it is enforceable depends solely on whether it is excessive in its amount. Some countries have, however, taken a more restrictive approach, and

¹⁴ Bürgerliches Gesetzbuch, (BGB) Article 343 BGB.

¹⁵ New Civil Code, art 94, Livre 6 and Code de Obligation Suisse art 163,3

¹⁶ Code Civil Article 1231

¹⁷ Supra note 9, at 654-655

¹⁸ Supra note 2, at 6.1

¹⁹ Ikko Yoshida, *Comparison on rewarding interest on damages in Scotland, England, Japan and Russia*, *Journal of International Arbitration* 17(2): 41–72, 2000. (Kluwer Law International) At 66 (see Civil Code article 330-331)

also examine the relationship between the penalty/liquidated damages and the actual loss suffered by the plaintiff. This approach is similar to the common law approach to liquidated damages.

Examples of a more Anglo-American approach

Denmark: The Supreme Court struck down a penalty clause due to a disproportionate penalty in relation to the contract price. The penalty in question was 4-6 times the contract price. The court also found that the plaintiff had not proved that he had actually suffered the corresponding loss.²⁰

Belgium: The Court established that the amount in a penalty clause can be declared unenforceable if the penalty amount “obviously exceeds actual damage”. However, the clause would not be voided, but the amount would be reduced.²¹

Examples of a more traditional civil law approach

Spain: A penalty clause was found to be unenforceable, since there was no connection to the main contractual obligation. The court did not discuss whether the amount was excessive or not.²²

Italy: The Court found that a penalty clause can be reduced if manifestly excessive or if the main contractual obligation has been partially performed. Mitigation may be ordered by the judge even if neither of the parties has asked for it.²³

Portugal: The Supreme Court upheld a penalty clause in a car lease contract, since the penalty was in proportion to the risk of a breach of the contract and loss of the value of the car.²⁴

²⁰ The Danish Højesteret 15 June 2004 (U.2004.4200H). From “*Recent Case Law*”, European Review of Private Law 2-2005 [225–263] (Kluwer Law International) at 234 section 4.1

²¹ The Belgian Hof van Cassatie/Cour de Cassation 16 December 2002 (nr. C.00.0176N). From “*Recent Case Law*” European Review of Private Law 2-2003 [235–263] (Kluwer Law International) at 257 section 4.5

²² The Spanish Tribunal Supremo 25 October 2004 [RJ 2004/6403]. From “*Recent Case Law*”, European Review of Private Law 2-2005 [225–263] (Kluwer Law International) at 234 section 4.1

²³ The Italian Corte di Cassazione, Sez. II, 29 May 2003, No. 8188. From “*Recent Case Law*” European Review of Private Law 2-2004 [259–290] (Kluwer Law International) at 267 section 4.1.

²⁴ The Portuguese Supremo Tribunal de Justiça 3 July 2003. From “*Recent Case Law*” European Review of Private Law 4-2004 [543–580] (Kluwer Law International) at 552 section 4.1

Conclusion

Even though the development of liquidated damages clauses seems to be moving toward a more uniform approach, a contract clause penalizing one party for non-performance or breach of contract will still be met with a different response in common law versus civil law jurisdictions. In a common law jurisdiction such a clause will not be enforced if it is not reasonable in proportion to the actual or anticipated damage, and if it is designed to penalize the breaching party. In civil law jurisdictions, the assumption is that a penalty clause is enforceable, but may be reduced if it reaches a certain level of excessiveness. In a comparison of the elements of the common law approach, the first step of deciding the difficulty of estimations of the actual damage is generally absent in civil law jurisdictions, except as one of many factors weighing in to the determination of "excessiveness". Since a clause that is purely a penalty can be enforced in civil law jurisdictions, there is no need to decide whether the intent behind having a liquidated damage clause is based on a real difficulty of estimation foreseen at the execution of the contract. The reasonableness test of common law jurisdictions can be compared to the civil law test of whether the penalty amount is "manifestly excessive" or "excessive", depending on the respective code. Most civil law systems will not assess the reasonableness of the penalty amount solely in relation to the actual harm, but will make an assessment based on a number of different factors. This leaves significantly more discretion to the courts to determine on a case-by-case basis what is permissible, and what may be "excessive" or "manifestly excessive", but the Resolution on Penalty Clauses adopted by the Council of Europe provides guidelines for use in exercising this discretion.
