ReedSmith

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The Critical Path

This edition of *The Critical Path* continues our emphasis on topics of interest in the national and international markets. The first article focuses on the different treatment of liquidated damages in some selected jurisdictions from around the world. The second article addresses an issue that is encountered frequently in most marketplaces, incorporation of documents by reference as part of the contract, although this article focuses on the U.S. market for this topic. Look for future editions of *The Critical Path* to expand on this topic in the international marketplace, as well as other topics with a broad scope that may be of interest to our readers.

As always, we appreciate feed back and suggestions from readers of topics of interest, so please feel free to send an email with suggestions and ideas for future editions of *The Critical Path*.

– *The Editors*

IN THIS ISSUE

Liquidated Damages and Penalty Clauses: A Civil Law versus Common Law Comparison

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 United States, but generally the courts consider two elements 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:

(continued on page 3, middle)

NEW YORK
LONDON
HONG KONG
CHICAGO
WASHINGTON, D.C.
BEIJING
PARIS
LOS ANGELES
SAN FRANCISCO
PHILADELPHIA
PITTSBURGH
OAKLAND
MUNICH
ABU DHABI
PRINCETON
N. VIRGINIA
WILMINGTON
BIRMINGHAM
DUBAI
CENTURY CITY
RICHMOND
GREECE

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Incorporation of Terms and Conditions by Reference: The "Clear Reference" Test

> Most jurisdictions use a version of the "clear reference" test to determine whether the referenced documents are properly incorporated into the applicable contract.

Construction, supply and other contracts frequently refer to other documents as part of the contract requirements, and often will incorporate other documents "by reference" to make them a part of the contract. This normally occurs because of the volume of information, and also as a method of simplifying the contract so that the obligations are clear among all the documents. Most jurisdictions use a version of the "clear reference" test to determine whether the referenced documents are properly incorporated into the applicable contract.

A leading case on the issue of incorporation by reference is *Standard Bent Glass Corp. v. Glassrobots Oy*, 333 F.3d 440 (3d Cir. 2003). In that case, the court stated the test as follows: "[i]ncorporation by reference is proper where the underlying contract makes clear reference to a separate document, the identity of the separate document may be ascertained, and incorporation of the document will not result in surprise or hardship." *Id.* at 447. Frequently the incorporated document is attached, so the identity issue should not normally be a problem. While it is important that there be no surprise or hardship, a mere failure to read the incorporated document does not create surprise or hardship. Thus, the crux of the test is the "clear reference" element.

Plans and specifications are frequently incorporated by reference, but disputes sometimes arise as to the extent of the incorporation of commercial terms. An example is *Westinghouse Elec. Supply v. Fidelity and Deposit Co. of Maryland*, 560 F.2d 1109, (3rd Cir. 1977). In the *Westinghouse* case, the issue was the intention of the parties when incorporating the phrase "plans and specs" of a general contract into a subcontract. The court ruled that the phrase "plans and specs" included more than merely the labor and material needed to perform the described work; it also included commercial terms of the general contract not specifically referred to in the subcontract that governed the method of compensation for changed or extra work. In this case, the commercial terms were incorporated by reference, even though not specifically referred to, because they were necessary to determine how to pay for the work. Therefore, the incorporation satisfied the "clear reference" test.

A more recent case occurred in Florida. In *Kaye v. Macari Bldg. & Design, Inc.* 967 So. 2d 1112, (Fla. Dist Ct. App. 2007), the contract clearly incorporated plans and specifications by reference. There was, however, an issue of whether an arbitration clause, part of an AIA form, was also incorporated by reference. The court determined that general notes on the plans and specifications made the form a part of the contract, and therefore the arbitration clause was a part of the contract, and the parties were required to arbitrate. The reference to the standard form on the general notes was sufficient to satisfy the "clear reference" test.

Occasionally this issue arises with respect to limitation of liability clauses, which may add an element of conspicuousness to the test. Some jurisdictions require that such clauses be in bold or capital letters to provide this added element, although in most jurisdictions, "…limitation of liability clauses are routinely enforced in contracts negotiated between sophisticated parties when the nature of the loss is commercial." *Advanced Tubular Products, Inc. v. Solar Atmospheres, Inc.*, 2004 WL 540019, *4 (E.D. Pa) Limitation of liability clauses are "…common place in the commercial arena." *Id*. at *6. They are an accepted way "…of allocating 'unknown or undeterminable risk'… and are a fact of every-day business and commercial life." Id. at *6.

This issue also arises in international contracts, and the rule frequently is similar. It is not unusual in the international marketplace to incorporate "standard terms and conditions." These can be terms and conditions from any applicable FIDIC form, or other standard form used in the industry.* Some jurisdictions refer to the test as to whether the incorporated terms have been "fairly and reasonably" brought to the attention of the other party. *See, e.g. Chitty on Contracts* para. 12-015 (English law). This seems similar to the "clear reference' test used in many places in the United States, but it also points out that there could be subtle differences, and the specific test used in any given jurisdiction is important to know when drafting contracts and using the incorporation technique.

– J. Frank McKenna and
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* See *Critical Path Fall* 2007 edition for a discussion of the FIDIC General Conditions.

Liquidated Damages and Penalty Clauses: A Civil Law versus Common Law Comparison (continued from page 1)

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, because of widely divergent approaches in different legal systems.[3] The enforceability of liquidated damage and penalty clauses thereby depends on domestic law.

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 UNICITRAL 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 toward 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 United States.) In recent years, however, there has been a widespread trend in civil law countries toward narrowing the scope of such penalties, and allowing

(continued on page 4)

Liquidated Damages and Penalty Clauses: A Civil Law versus Common Law Comparison (continued from page 3)

> Although penalty clauses have been generally enforceable in civil law countries, they can now be mitigated by the court in most jurisdictions.

courts to reduce the amount if they find it excessive.

Traditionally, in civil code countries, no distinction was made 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 United States because of 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 jurisdictions.[7] The Council of Europe issued a "Resolution on Penalty 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 performed.[8]

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 penale" (penalty clause), and article 1152 regulates "dommages-interets" (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.

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 of 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 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 because of a disproportionate penalty in relation to the contract price. The penalty in question was four to six 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]

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

(continued on page 6)

Commissioning the Way to Building Success (continued from page 1)

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.

– J. Frank McKenna

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[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

[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/ Verstragsstrafe," *European Review Private Law* 1:149-155, 2001 (Kluwer Law International.) at 149

[7] Scottish Law Commission, Penalty Clauses, (Scot Law Corn No 171) 1999, at 2-3

[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 l382 in Codice Civile regulates penalty clauses.

[12] *Id*. article 1184

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

[14] Burgerliches 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)

[20] The Danish Hojesteret 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 Justica 3 July 2003. From "Recent Case Law," *European Review of Private Law* 4-2004 [543-580] (Kluwer Law International) at 552 section 4.1

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