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"Lost on Penalties — A Penalty Shoot-Out between England and Germany (and a few other jurisdictions)"

Abstract:

The treatment of penalty clauses and liquidated damages clauses has long been a staple topic of Law & Economics and Comparative Law textbooks. Various legal systems limit the enforcement of penalty clauses to a greater or lesser extent. Common law jurisdictions do not enforce penalty clauses at all, and various civil law jurisdictions put limits on the extent of their enforcement. This is, from the legal perspective, a limitation on the party's freedom of contract and, from an economics perspective, restricts Coasean bargaining.

Both common and civil law jurisdictions single out penalty clauses for this special treatment. Alternative contract clauses serving objectives very similar to those of penalty clauses ("alternative arrangements"), such as liquidated damages clauses or agreements on differentiated primary obligations conditional on events that are not a breach, largely or completely escape special treatment. In light of the functional exchangeability of penalties and these alternative arrangements, the legal differentiation appears at best curious. Unease with the differentiation has resulted in a moving of the goalposts in recent years in some jurisdictions (most prominently in Australian and English contract law).

There is, however, little impetus to tackle the more fundamental question what the precise purposes of the rules against (or on) penalties are. Once the purposes are properly defined, the question arises whether these purposes, if they are indeed strong enough to justify the inroads into freedom of contract and Coasean bargaining in the case of penalty clauses, also require modifications in the approach to functionally equivalent alternative arrangements in order to avoid inconsistencies (and the penalty rule becoming a mere trap for the unwary). Fluid boundaries between penalty clauses and alternative arrangements are particularly problematic if the qualification as a penalty clause or as an alternative arrangement results in starkly different outcomes.

A consistent approach to penalties and alternative arrangements is of great, and arguably increasing, practical significance. In addition to their wide-spread use in consumer contracts (bank charges, parking fees...), penalty clauses or alternative arrangements are used to allocate risks in large-scale commercial contracts, public-private partnerships, and performance-based logistics.

The presentation describes the developments from a comparative perspective, and describes a framework for a more consistent approach.