"Social Transformations in Contemporary Society", 2013 (1)
ISSN 2345-0126 (online)

PENALTY CLAUSES WITHIN DIFFERENT LEGAL SYSTEMS

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Abstract

In this article the regulation in regard of penalty clauses within two different legal traditions, i.e. common law tradition and continental law tradition, is analyzed. In general a penalty clause implies a fixed sum, which has to be paid by a party for the failure to perform its contractual duties timely and duly. In common law world penalty clauses are rendered unenforceable, whereas civil law countries, including the Republic of Lithuania, consider such clauses enforceable to the extent that the stipulated amount is not excessive. Moreover, in the article attempts to reach a uniform regulation throughout various legal instruments are revealed.

Purpose: to analyze the regulation of penalty clauses within different legal systems.

Methodology: a systematic method was used in order to ascertain the content and true meaning of the legislation concerning penalty clauses, whereas comparative method allowed comparing such legislation among different jurisdictions. On the basis of analytical method conclusions were withdrawn.

Findings: common law courts on the basis of just compensation principle may declare a clause, which stands for a penalty, unenforceable, whereas civil law courts may only reduce grossly excessive amount. However, under major soft law instruments, such as the UNIDROIT Principles[1], PECL[2] and DCRF[3], the divergence from common law rules of non-enforcement of penalty clauses is evident. Although there is a lack of binding transnational rules that control the enforceability of penalty clauses across the countries, it seems that today the most feasible solution consists of the approval of national rules, which would shield the enforcement of penalties in international commercial contracts in common law jurisdictions.

Research limitations: in the light of the civil law system terms of liquidated damages and penalty clause are used interchangeably, since both are enforceable. However, a distinction between the two can be made on the basis that a liquidated damages clause is used to estimate damages in case of breach, provided that there has been an actual harm to the plaintiff, whereas

[1] UNIDROIT Principles of International Commercial Contracts 2010 [interactive]. [accessed 2013-03-14]. <http://www.unidroit.org/english/principles/contracts/main.htm>. [hereinafter UNIDROIT Principles]

[2] Commission on European Contract Law, Principles of European Contract Law 2002 [interactive]. [accessed 2013-03-14] <http://www.jus.uio.no/lm/eu.contract.principles.parts.1.to.3.2002/>. [hereinafter PECL]

[3] Study Group on a European Civil Code and the Research Group on EC Private Law. Principles, Definitions and Model Rules of European Private Law. Draft Common Frame of Reference. Full Edition. Vol. 1. Munich: Sellier. European Law Publishers, 2009. [hereinafter DCRF]

ISSN 2345-0126 (online)

a penalty clauses is used to establish a penalty to be paid in case of breach with the intent to encourage performance. The latter also does not require proof of any real damage.

Practical implications: the article initiates a discussion on the importance of ensuring the legal certainty in contractual relations, particularly in the field of enforceability of penalty clauses, not only on the national but also on the international level.

Originality/Value: in the law of contracts the clash of common law and civil law in respect of the treatment of penalty clauses has drawn a lot of attention of scientists and researchers; however, the question of this article, i.e. how to eliminate the clash between two different legal systems and to achieve binding uniform regulation that would control the enforceability of penalty clauses, remains of high importance.

Keywords: common law system, civil law system, penalty clause, liquidated damages.

Research type: general review.

Introduction

The law on penalty clauses perfectly reflects the tension found throughout contract law, which is common to most jurisdictions and to all periods of contractual history. In the common law world penalty clauses have been void for three centuries (McCormick, 1935). Such level of legal uncertainty has been reached throughout the means of paternalistic interference with contractual freedom. On the other hand, civil law perhaps went too far in the other direction. For example, in accordance with the Napoleonic Code, which was the basis for other European civil codes, if parties entered an agreement, it meant they stated the law, which could not be modified by the court, even if the amount to be paid for the breach was excessive (Fontaine and De Ly, 2009). Nevertheless, today some degree of convergence between common law and civil law systems, which will be further in this article explained, has happened.

I: The Common Law Approach

In common law world there is a strict distinction between liquidated damages and penalty clauses (Mattei, 1997). The distinction between the two is based on their different nature, i.e. the former is used for compensatory purposes, whereas the later is used to deter the breach. In other words, the liquidated damages clause represents a genuine pre-estimate of damages, while the penalty clause is stipulated as in terrorem of the offending party (Miller, 2004). Even though these functions may overshadow one another (especially in cases where the intention of the parties is not clear, or where they tend to include both a coercive and compensatory element to the clause), the general rule under the common law is that a payment clause is only enforceable when it functions as a liquidated damages clause. So despite the fact that contractual parties are free to bargain all matters, common law judges maintain a broad level of discretion over the choice of remedy (Farnsworth,1970).

It seems that common law judges tend to avoid the introduction of any form of punitive damages (in addition to compensatory damages) for the breach of a contract

ISSN 2345-0126 (online)

because supposedly "the mere availability of such a remedy would seriously jeopardize the stability and predictability of commercial transactions, so vital to the smooth and efficient operation of the modern [...] economy"[1]. According to the common law theory of "efficient breach", it is considered that as long as the aggrieved party receives monetary damages compensating for its expectation loss, breach will be more efficient than performance (Posner, 2011). Moreover, under the common law conception of damages, awarded damages should compensate the claimant and not exceed his actual loss[2]. Based on such conception of damages the House of Lords in one of its cases stated that a clause in a contract that stipulates for a sum, which is in excess of the actual loss of the obligee, is considered illegitimate[3]. Common law judges distinguish liquidated damages from penalty clauses by comparing the clause, which may include either penalty or liquidated damages, with conventional damages. In case of substantial difference between the two, it would be concluded that the liquidated damage clause is a penalty and therefore unenforceable (McKendrick, 1997). Further it would be presumed that the contract was silent on a certain amount, which was set out to be paid as damages for the breach of contractual obligations, and a conventional remedy would be awarded to the aggrieved party.

American law, which was greatly influenced by the Uniform Commercial Code[4] and Restatement 2d Contracts[5], has formulated two conditions which must be satisfied in order for the stipulated sum not to fall under the definition of a penalty clause: (i) the stipulated amount must be reasonable (i.e. not grossly disproportionate) in light of the harm anticipated by the parties or the actual harm caused by the breach; (ii) due to subjective valuation, uncertainty, difficulty of producing proof of damages, or any other measurement problems it is difficult or impossible to measure – and thus prove – the presumable loss (Hatzis, 2002). Hence, today American courts apply one single test of reasonableness with two elements, namely the disproportion of the agreed sum and the difficulty of proof of loss, in order to determine whether a liquidated damages clause does not actually function as a penalty clause. Most other common law countries, such as

[1] The Court of Appeals of Maryland in General Motors Co v. Piskor, 281 Md. 627, 381 A.2d 16 [1977].
[2] The Privy Council in Tai Hing cotton Mill v. Kamsing Knitting Factory [1979] AC 95, at 105.
[3] The House of Lords in Export Credits Guarantee Department v. Universal Oil Products [1983] 1 WLR 399, at 155.
[4] American Law Institute and the National Conference of Commissioners on Uniform State Laws, Uniform Commercial Code 2003, at § 2-718(1) [interactive]. [accessed 2013-03-14] <http://www.law.cornell.edu/ucc/>. "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 non-feasibility of otherwise obtaining an adequate remedy. A term fixing unreasonably large liquidated damages is void as a penalty".
[5] American Law Institute, Restatement (Second) of Contracts 1979, at § 356 (1) [interactive]. [accessed 2013-03-14] <http://www.lexinter.net/LOTWVers4/restatement_(second)_of_contracts.htm>. The text provides almost the same rules as Uniform Commercial Code.

ISSN 2345-0126 (online)

England, Australia, Ireland and Canada, have similar rules in respect of liquidated damages and penalty clauses[1].

When classifying the clause either as a penalty or liquidated damages under English law, the court will take into account the intention of the parties as to its purpose in order to distinguish whether the clause is genuinely to calculate loss in advance or to punish a party, which is at fault for the breach of contract[2]. In other words, the court will scrutinize whether the stipulated sum, which is intended by the parties to be compensation *ex ante* (at the time of contract negotiation and drafting), is not "extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have followed from the breach"[3]. Nevertheless, in *Jobson v. Johnson* the English court established different rules, compared to the general common law approach, in regard of clauses classified as penalties. According to *Jobson v. Johnson*, if the clause is classified as a penalty, it is not simply struck out of the contract but rather "remains in the contract and [even] can be sued on"[4]. However, it was also added by the court that such clause "will not be enforced by the court beyond the sum which represents the actual loss of the party seeking payment"[5].

It can be concluded that common law courts render penalty clauses unenforceable, though the English court ruling in *Jobson v. Johnson* seems to show an exception to the general approach. However, it must be borne in mind that under English law a stipulated sum will be only enforced to the extent that it does not function as a penalty simply by "scaling-down" the clause to the actual loss, whereas if the actual loss is more, then the clause will act as a limitation on recoverable damages (Whincup, 1997). By "scaling-down" the clause and enforcing it to the extent that it does not function as a penalty the court is, in principle, modifying the clause, which could be viewed as confirming a subtle convergence of approach between common law and civil law traditions, especially since most civil law countries instituted the power of the judge to limit excessive penalty clauses.

II: The Civil Law Approach

In the narrow sense, penalty clause may be considered a sum of money, which is to be paid for the failure of performance of contractual duties (Vasarienė, 2002). It is

[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, as well as 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] The Court of Queen's Bench in Law v. Redditch Local Board [1892] 1 QB 127, at 132.
[3] Dunlop Pneumatic Tyre Co. Ltd. v. New Garage & Motor Co. Ltd. [1915] AC 79.
[4] The House of Lords in Jobson v. Johnson [1989] 1 WLR 1026, at 1040.
[5] Ibid.

ISSN 2345-0126 (online)

important to note that civil law countries share the same concept, under which the penalty clause is defined as a provision seeking to encourage the performance of contractual obligations (Ambrasienė et al, 2009). Under the civil law system penalty clauses can be viewed as the kind of liquidated damages that would not be enforceable in common law countries due to the public policy, which prohibits clauses designed to deter the breach by requiring the payment of extra-compensatory damages. In contrast to common law jurisdictions, penalty clauses do not have to be a reasonable estimate of what future damages will be, because civil law judges only check the general reasonableness of a penalty clause at the moment of enforcement rather than at the time of contract negotiation and drafting. It means that if the clause seems reasonable *ex post*, it may stand although it is unreasonable *ex ante*, which is an unlikely outcome in the common law perspective.

In Europe penalty clauses have been enforceable since Roman times, as under the classical Roman law there was a rule of the literal enforcement of penalty clauses, with a purpose to encourage performance of contractual obligations (Zimmermann, 1990). The Napoleonic Code, as enacted in 1804, followed the mentioned classical Roman law rule of literal enforcement of penalty clauses. The regime introduced by the Napoleonic Code did not discriminate between penalty clauses and any other contract clause. So if parties had included a penalty clause into the contract, then it could have been possible to challenge such clause only by challenging the entire contract (at least up until 1975). Many European civil codes were based on the Napoleonic Code and provided similar rules of the literal enforcement of penalty clauses (Garcia, 2012).

Nevertheless, in recent years the liberal Roman principle of the literal enforcement of penalty clauses has been progressively abandoned. There has been a widespread trend in European laws towards narrowing the scope of penalty clauses and allowing courts to reduce the amount, if they find it excessive. For instance, in 1975 Article 1152 of the French Civil Code was amended to provide: "Nevertheless, the Judge may reduce or increase the agreed-upon penalty if it is manifestly excessive or ridiculously small. Any contrary stipulation will be considered not written" (Schlesinger et al, 1988). The rule as it applies to excessively high penalty clauses is substantially in accord with the German Civil Code Section 343[1], Swiss Code of Obligations Article 163[2] and other European laws. For example, Article 6.73-3 of the Civil Code of the Republic of Lithuania also legitimates the reduction of manifestly excessive penalty clauses[3], but, as the Supreme Court of Lithuania provided, due to the principle of freedom of contract the amount should be still higher than actual damages[4]. This Continental law evolution shows some degree of convergence between civil law and common law, if it is true that common law courts, as

[1] German Civil Code 2012 [interactive]. [accessed 2013-03-14] <http://www.gesetze-iminternet.de/englisch_bgb /englisch_bgb.html#p1192>.
[2] Swiss Code of Obligations 2013 [interactive]. [accessed 2013-03-14] <http://www.admin.ch/ch/e /rs/2/220.en.pdf>.
[3] Civil Code of the Republic of Lithuania. Official Gazette. 2000, No. 74-2262.5.
[4] The Supreme Court of Lithuania, Civil Division, 12 October 2007 ruling of the board of judges in the civil case J. N. v. T. M., V. M [case No. 3K-7-304/2007].

ISSN 2345-0126 (online)

Jobson v. Johnson shows, are becoming somewhat more liberal in their interpretation of the ban on penalty clauses.

The process of evolution was encouraged by the Council of Europe, which in 1971 issued a Resolution on Penalty Clauses[1], with the aim of recommending a uniform application of penalty clauses for the member states to use. According to the Resolution, courts may reduce the penalty amount, if it is manifestly excessive, or if part of the main contractual obligation of the contract is performed[2]. The Explanatory Memorandum to the Resolution in determining whether a penalty is manifestly excessive provides a list of factors, which include: (i) the comparison of the pre-estimated damages to the actual harm; (ii) the legitimate interest of the parties, including non-pecuniary interests of the obligee; (iii) 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; (iv) whether it was a standard-form contract; (v) and whether the breach was in good or bad faith. Many European codes have followed the Resolution to allow courts to reduce excessive penalty clauses, while national courts began establishing lists of criteria, which are similar to those set out within the Explanatory Memorandum, for determining the excessiveness of penalty clauses[3]. Thus, the Resolution might be viewed as the European civil law model of penalty clauses, provided that main characteristics are: (i) the validity of penalty clauses, which may have the effect of coercing a party to perform its contractual duties; (ii) the judicial review of penalty clauses on the grounds of manifest excessiveness, or on the grounds of partial performance; and (iii) the obligee's entitlement either to the penalty or to specific performance, with the exception of delay.

In sum, even though some degree of convergence between common law and civil law systems seems to exist, a contract clause penalizing one party for non-performance or breach of the contract will still be met with a different response in common law versus civil law jurisdictions. Most common law courts on the basis of just compensation principle may still declare a clause, which stands for a penalty, unenforceable, whereas civil law courts may only reduce grossly excessive amount.

III: Attempts to Reach a Uniform Approach

Nowhere in the law of contracts has the clash of common law and civil law notions seemed as irreconcilable as in the treatment of penalty clauses (Perillo, 1994). The lack of transnational rules that control the enforceability of penalty clauses in international commercial contracts puts at risk the will of the contracting parties (Garcia, 2012). Many attempts have been made in order to harmonize two different legal approaches, but harmonization projects usually opted for civil law principle of enforcement of penalties

[1] Penal clauses in civil law, Resolution No. (78) 3, adopted by the Committee of Ministers of the Council of Europe on 20 January 1978 and Explanatory Memorandum (Strasbourg, 1978). [hereinafter Resolution]
[2] Ibid. Article 7.
[3] The Supreme Court of Lithuania, Civil Division, 12 October 2007 ruling of the board of judges in the civil case J. N. v. T. M., V. M [case No. 3K-7-304/2007].

ISSN 2345-0126 (online)

subject to reduction. Such a choice involved the understandable rejection of common law approach, and it was the main reason why the UNCITRAL Uniform Rules[1] failed to come into force (Solorzano, 2009).

Outside the domain of treaties, major soft law instruments, such as the UNIDROIT Principles, PECL and DCFR, have tackled the issue of transnational regulation in regard of penalty clauses. However, none of them is legally binding for states, albeit potentially useful because parties may designate one of them as applicable law. The UNIDROIT Principles[2], PECL and DCFR[3] resolved the issue, similarly to the UNCITRAL Uniform Rules, by following the civil law principle of enforcement of penalty clauses subject to reduction.

Further we will analyze different views towards the United Nations Convention on the International Sale of Goods (CISG)[4], which is an instrument setting rules for the transnational regulation over agreed sums. Some authors state that the validity of penalty clauses is directly governed by the CISG, and therefore avoids any need to resort to domestic national law under Article 4 of the CISG (Schlechtriem and Schwenzer, 2010). Even though the CISG does not expressly address the issue of penalty clauses, Zeller (2011) asserts that when the amount of the contractual clause is judged to be more than the actual damages, the excess can be accommodated within the CISG by two its general principles, namely freedom of contract and compensation for losses. According to Zeller (2011), penalty clauses fall under Article 74 of the CISG, since the first sentence this Article addresses situations where the contract simply is silent on the consequences of a breach of contract, while the second sentence caps the losses to the sum, which the party ought to have foreseen "at the time of the conclusion of the contract". Article 7.4.2 of the UNIDROIT Principles may be used as guidance in defining the scope of Article 74 of the CISG to include "(1)[…] any loss which [aggrieved party] suffered and any gain of which it was deprived, taking into account any gain to the aggrieved party resulting from

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

[2] UNIDROIT Principles of International Commercial Contracts 2010, Article 7.4.13(1) [interactive]. [accessed 2013-03-14]. <http://www.unidroit.org/english/principles/contracts/main.htm>. "(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".

[3] For Similar rules, which are set out in Article 7.4.13(1) of the UNIDROIT Principles, see Commission on European Contract Law, Principles of European Contract Law 2002, Article 9:509 [interactive]. [accessed 2013-03-14] <http://www.jus.uio.no/lm/eu.contract.principles.parts.1.to.3.2002/>. See also, Study Group on a European Civil Code and the Research Group on EC Private Law. Principles, Definitions and Model Rules of European Private Law. Draft Common Frame of Reference. Full Edition. Vol. 1. Munich: Sellier. European Law Publishers, 2009. Article III-3:712.

[4] United Nations Convention on Contracts for the International Sale of Goods 2010 [interactive]. [accessed 2013-03-14]. <http://www.uncitral. org/pdf/english/texts/sales/cisg/V1056997- CISG-e-book.pdf>. [hereinafter CISG]

ISSN 2345-0126 (online)

its avoidance of cost or harm; (2) such harm may be non-pecuniary and includes, for instance, physical suffering or emotional distress". In this vein one could conclude that Article 74 of the CISG allows recovering damages that have gone beyond the confines of a breach between two parties.

However, traditional commentaries on the CISG have consistently concluded that the validity of a penalty clause must be determined by reference to domestic national law under Article 4 of the CISG (Honnold and Flechtnered, 2009). The CISG Advisory Council provided that all domestic protection mechanisms[1] generally remain applicable to agreed sums, because the CISG is not concerned with questions of validity. It means that in the event of breach the validity of a penalty clause will depend on the applicable domestic national law, according to which such clause may be rendered valid in some jurisdictions and invalid in others (Graves, 2012). Nevertheless, the CISG Advisory Council added that both legal systems prohibiting penalty clauses and legal systems employing a reduction mechanism must respectively decide whether a stipulated sum is a genuine pre-estimate of the loss, or whether a penalty amount is excessive by applying an international standard rather than domestic one[2].

In conclusion, Article 4 of the CISG provides that domestic law governs the validity of fixed sums, however, one must apply international standards in interpreting and applying that domestic law – notwithstanding domestic interpretations to the contrary (Hachem, 2011). It is reasonable to agree with Garcia (2012) that due to the lack of binding transnational rules in the realm of enforceability of penalty clauses, today the most feasible solution consists of the approval of national rules, which would shield the enforcement of penalties in international commercial contracts in common law jurisdictions.

Conclusions

1. Common law courts may either declare a clause, which penalizes one party for non-performance or breach of contract, unenforceable on the grounds of just compensation, or if it is English courts settling a dispute between the parties, leave such clause enforceable to the extent that it does not function as a penalty.

2. Although major soft law instruments, such as the UNIDROIT principles, PECL and DCFR, are non-binding, the divergence from common law rules is evident, as they opted for the principle of enforcement of penalty clauses subject to reduction on the grounds of manifest excessiveness.

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[1] The CISG Advisory Council Opinion No. 10, 2012, at 3.3 [interactive]. [accessed 2013-03-14] <http://www.cisg.law. pace.edu/cisg/CISG-AC-op10.html>. The following protection mechanisms concern the validity of agreed sums: (i) "Where domestic laws establish fixed amounts for agreed sums, these provisions determine to what extent an agreed sum is valid". (ii) "Where a legal system denies enforceability to agreed sums classified as penalties, the function of the clause determines the validity of the entire clause". (iii) "Where a legal system provides for the reduction of excessive sums, such provisions determine the extent to which an agreed sum is valid".

[2] Ibid, at 4.2.2.

3. Under the CISG domestic protection mechanisms remain applicable to fixed sums, meaning that it is up for member states to decide whether to deny enforceability to fixed sums, which are classified as penalties, or provide for the reduction of excessive amounts.

4. Despite the lack of transnational rules in the realm of enforceability of penalty clauses, today the most feasible solution consists of the approval of national rules, which would shield the enforcement of penalties in international commercial contracts in common law jurisdictions.

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