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THEORETICAL AND PRACTICAL ASPECTS OF LIQUIDATED DAMAGES AND APPLICATION UNDER THE LAW OF THE REPUBLIC OF LITHUANIA

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Abstract

Purpose – the purpose of this article is to analyze the theoretical and practical aspects of liquidated damages in the light of commercial contracts and evaluate the potential application of liquidated damages under the law of the Republic of Lithuania.

Methodology – in the research theoretical methods (analytic, systemic and historical) are applied.

Findings – within the common law the traditional approach, under which the enforceability of liquidated damages rests upon difficulty of proof of loss and the disproportion of the agreed sum, compared to the anticipated or actual harm, is relatively rigid from the point of view of commercial contractors with equal bargaining power that seek for a legal instrument conveying information about a party's intent or capability to perform under the contract. Recently adopted commercial justification test applicable to liquidated damages that exceed genuine pre-estimate of loss seems to resolve this problem to some extent. The Civil Code of the Republic of Lithuania[1] (hereinafter "CC") establishes a limited list of grounds to void agreements, so unless the legislative process separating liquidated damages from penalties as a separate form of liability and incorporating additional grounds on voiding stipulated amounts takes place, there will be no other judicial tool available for Lithuanian courts to control unreasonably excessive and/or unfairly agreed amounts, rather than reducing them.

Research limitations – in this article the research is limited to the analysis of theoretical and practical aspects of liquidated damages in the contemporary legal relationships between commercial parties that of relatively equal bargaining power. The author analyzes and evaluates potential application of liquidated damages under the law of Lithuanian Republic, only when liquidated damages are integral with the commercial justification test.

Practical implications – the article initiates a discussion whether adopting a similar test to commercial justification that would apply to penalties under the CC would enhance the legal certainty and parties' autonomy in contractual relationships in Lithuanian Republic, or perhaps a more radical solution is required, such as establishing liquidated damages as a separate form of liability, with additional grounds for voiding the liquidated damages clause, based on the unreasonableness of the agreed amount and/or unfairness of the contract process.

[1] Civil Code of the Republic of Lithuania. Official Gazette. 2000, No. 74-2262.5.

Originality – there are only few scholars that analyzed the concept of liquidated damages and dealt with some aspects concerned with the application of liquidated damages under the law of Lithuanian Republic. Meškys (2012) separated liquidated damages from penalties and considered that the Supreme Court of Lithuania established liquidated damages as an independent form of security of obligations under CC 6.70(1), whereas Bublienė and Truskaitė-Paškevičienė (2013) disagreed with this position by concluding that deterrence of the breach and securing contract performance is incompatible with the purpose of liquidated damages and that under the Article 6.256(2) of the CC liquidated damages may only function as a penalty. Nevertheless, the questions, such as whether liquidated damages together with the commercial justification test meet the needs of today’s commercial world in terms of legal certainty and parties’ autonomy in contractual relationships, furthermore, what exactly prevents liquidated damages from being applied under the law of Lithuanian Republic, remain unanswered.

Keywords: liquidated damages, penalty, equal bargaining power, commercial justification.
Research type: general review.

Introduction

In the first chapter of this article the concept of liquidated damages is introduced, and also the criteria determining the validity of the liquidated damages clause are defined. It is important to note that within the common law realm the justification of paternalistic approach towards penalties (unenforceable liquidated damages) lies in ideas, such as equity, protection of a weaker party, efficient breach, however, one of counterarguments raised in the first chapter is that when determining the enforceability of the liquidated damages clause a fair amount of consideration has to be given to the sophistication of parties and their equal bargaining power. In the second chapter the case law, which indicates a shift in common law jurisdictions from a strictly paternalistic approach towards a softer approach, is reviewed. The main reason of this shift lies in the commercial justification test, so further the main characteristics of this test is analyzed. In the final chapter the liquidated damages clause and penalty under the CC are compared, as well as some conclusions on potential application of liquidated damages under the law of Lithuanian Republic are drawn.

The Dunlop Test and Intervention with Parties’ Autonomy

The contract law allows independent individuals voluntarily participate in legal transactions and impose upon each other rights and obligations that correspond to their own will. This is ensured by the principle of parties’ autonomy, in accordance of which courts should fully enforce contracts the way they are negotiated between parties. Nevertheless, the principle of parties’ autonomy is not absolute because certain criteria have to be satisfied to make the contract valid and enforceable, for instance, generic requirements of genuineness of assent, consideration, capacity and legality (DiMateo, 2006). Moreover, specific clauses, such as liquidated damages, have certain requirements that are applicable particularly to them.

The main focus of this article is precisely on liquidated damages, which are a common law remedy ensuring compensation for breach of the contract. Liquidated damages are considered to be a genuine pre-estimate of likely loss flowing from breach. The advantages of this clause are that non-breaching party avoids the obligation to prove its loss and escapes certain expenses, such as litigation costs. The restriction of the clause is that courts may render it unenforceable, provided stipulated amount is grossly disproportional in the light of anticipated or actual harm caused by the breach, and also in case there is no difficulty of producing the proof of damages or measure – and thus prove – the presumable loss (Hatzis, 2002). Within the common law liquidated damages rendered unenforceable are qualified as penalty (in chapters I and II of this article the term “penalty” is particularly used to define unenforceable liquidated damages).

The line of authority, based upon which courts determine the enforceability of liquidated damages, was first established in the Dunlop case[1]. In this case the dispute arose between the manufacturer and dealer, who made an agreement concerning the sales of tyres. The agreement stated that the dealer was only allowed to sell tyres that it bought from the manufacturer for the price, which is not less than the list price. The parties had also agreed that if the dealer breaches this condition, it would have to pay liquidated damages in £5 per each tyre. The House of Lords held that the stipulated amount was not a penalty because damages were impossible to forecast and the amount to be paid was a genuine pre-estimate of the likely loss flowing from breach.

The roots justifying paternalistic intervention with parties’ autonomy lies in equity law (LaFiura and Sager, 2001). The initial motivation for rendering penalties unenforceable was the protection of weaker parties. Later on a less paternalistic idea contributed to justify the non-enforcement of penalties. This idea is based on the principle of “efficient breach”, which is best explained with the following: “if parties are free to break their bargains should a better deal come along, rational actors will breach their first contract, pay the expectancy damages to the obligee, and pursue the more lucrative alternative. Presumably, this will have a net benefit to society because resources are being channeled to the user who values them most” (Solorzano, 2011). So from the economist’s point of view it is considered that the ban on penalties and predominance of the principle of “efficient breach” serves society, as long as a party, who concludes that they would incur a greater economic loss by performing under the contract, is entitled to voluntarily breach that contract and pay either damages or agreed amount, which is a genuine pre-estimate of loss. However, this is a general idea that cannot be viewed as a specific standard enabling courts to evaluate paternalistic arguments in every individual case, as only in this way the limits of paternalism can be defined and its legitimacy established (Kronman, 1991).

We could agree that the refusal to enforce penalties is reasonable to some extent, especially considering the protection of weaker parties. However, the same level of protection should not apply to commercial parties, such as large corporations, that are sophisticated and have equal bargaining power. The question is why a court should necessarily concern itself with the matter and display parental solicitude for large

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[1] Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd [1915] AC 79.

corporations by refusal to enforce penalties, provided the clause was freely bargained. It seems that the law of liquidated damages fails to distinguish a highly negotiated clause between parties of relatively equal bargaining power and a clause that is not a product of negotiation, such as in an adhesion contract between parties of unequal bargaining power.

The Dunlop test, in accordance of which the enforceability of liquidated damages mainly rests upon difficulty of proof of loss and the disproportion of the agreed sum, is relatively rigid from the point of view of commercial contractors that seek for a more versatile legal instrument. How can liquidated damages allocate risk, provide compensation in the event of breach and convey information about a party’s intent or capability to perform under the contract? It is possible, only if courts applying the Dunlop test would start taking into consideration the relationship between the parties, the sophistication of the parties agreeing to the contract, or other contextual factors relating to the inclusion of the stipulated amount. As the recent case law within common law jurisdictions indicates, the commercial justification test applicable to liquidated damages that exceed genuine pre-estimate of loss seems to resolve this problem to some extent. The application and characteristics of this test are further analyzed in the following chapter.

The Commercial Justification Test and Strengthening Parties’ Autonomy

As it was noted in the previous chapter, traditional criteria determining the enforceability of liquidated damages are the difficulty of proof of loss and the disproportion of the agreed sum to the anticipated or actual harm. One of the recent cases, in which the court did not follow the traditional approach, is the Azimut case[1]. The English High Court established a new line of authority, in accordance of which it must be decided whether liquidate damages are in fact a penalty and therefore unenforceable by applying the commercial justification test. This test rests upon two criteria: firstly, the court must be convinced there is a commercial justification for the difference between the agreed sum and likely loss; and, secondly, it must be persuaded that the clause does not have the dominant purpose of punishing or deterring the breach. If both criteria are satisfied, the liquidated damages clause will not be invalidated as a penalty, merely based on the difference between the agreed sum and likely loss.

In the Azimut case the dispute arose between the yacht builder and buyer. According to the terms of the contract, the yacht builder was obliged to build up a 60-meter long yacht, whereas the buyer was obliged to pay for it £38 million in installments over the period of 3 years. The contract included a provision entitling the yacht builder to retain (or recover) 20 percent of the contract price as liquidated damages, provided there is a late payment on part of the buyer. The contract also stated, if the yacht builder chose to terminate the contract in this way, it was obliged to return any other part of the contract price it had already received. This kind of formulation of liquidated damages

[1] Azimut-Benetti SpA (Benetti Division) v Darrel Marcus Healey [2010] EWHC 2234 (Comm).

provision stroke a balance between interests of the parties. After the buyer failed to carry out its obligation to pay on time, the yacht builder terminated the contract and simultaneously demanded payment of liquidated damages. Then the question was raised whether liquidated damages clause stood for a genuine pre-estimate of loss. After considering that both parties were of equal bargaining power and had the benefit of legal representation, the court upheld liquidated damages clause as it was negotiated.

Another similar case that reveals courts' reluctance to qualify liquidated damages clauses as penalties when parties are sophisticated business entities and the damages are economic also concerns the dispute between the buyer and ship builder[1]. The builder agreed to build up a vessel for $25 million and for each day that the vessel was not delivered agreed to pay $17,000 per day in liquidated damages. The builder did not complete the vessel on time and non-breaching party suffered $368,000 in actual damages, nevertheless, the breaching party was forced to pay approximately $3.3 million in liquidated damages in accordance to liquidated damages clause. The court upheld the clause, since both parties were of relatively equal bargaining power, comparable level of sophistication and had legal representation. After all, each party accepted the risk of its turning out in particular way, why should it be released from the contract, provided there were no misrepresentation or other deficiency of fair dealing?

Nevertheless, the circumspection that courts show before striking down the clause when parties are of equal bargaining power does not entirely displace the rule that the stipulated amount must be a genuine pre-estimate of loss. The common law courts generally will enforce contracts freely entered into by sophisticated parties, but they will still draw the line where liquidated damages are unreasonable given the nature of the harm. Courts will closely consider any major difference between the amount payable and the loss that might be suffered and where this difference is "out of all proportion", the court is likely to intervene[2].

We may conclude that the deterrence of the breach is considered to be the dominant purpose of the clause when the agreed sum is "out of all proportion" to the likely loss. The court may also focus on the nature of the relationship between the parties in order to determine whether that relationship was oppressive and the dealing was unfair. The High Court of Australia observed that a mere difference in amount is not enough, let alone the suspicion of that difference; the comparison calls for a degree of disproportion sufficient to point to oppressiveness[3]. Nevertheless, the oppression on a party to make a contract is not of itself a criterion in determining whether a contractual sum is a penalty[4].

The commercial justification test motivates common law courts to uphold the primacy of the parties' agreement to the greatest extent possible. Nevertheless, the gap between the parties' desire to legislate for their own remedial structure and the law's

[1] California & Hawaiian Sugar Co v Sun Ship Inc, 794 F2d 1433 [1986]; cert den 484 US 871 [1987].
[2] Wilmington Trust Co v Global Aero Logistics Inc., No. 600401/09 (N.Y. Co. April 11, 2011); Cavendish Square Holdings BV v Makdessi [2013] EWCA Civ 1539.
[3] Ringrow Pty Ltd v BP Australia Pty [2005] 224 CLR 656.
[4] Murray v Leisureplay Plc [2005] EWCA Civ 963.

ability to achieve that goal inevitably remains because the compensatory model supports the doctrine of penalties, with its underpinnings in the prohibition upon deterrence (Bell, 2012). It seems unlikely that the commercial justification test will completely resolve the problem of uncertainty in determining the lines between a valid liquidated damages clause and an invalid penalty, unless the kind of notion that is supported by scholars, such as Coopersmith (1990), who focus on the unfairness of the contract process, prevails in the law of liquidated damages. It is worth noting that, historically, the doctrine of penalties looked namely to unfairness, rather than unreasonableness; and that unfairness was considered in relation to the contract process, rather than outcome. If unreasonableness of the agreed sum, even extreme one, was only relevant as an indication of oppression or unfairness in the contract process, then the main consideration for the courts would become the willingness of the parties as to the agreed sum. Whether the law of liquidated damages together with the commercial justification test will evolve in this way remains to be seen.

Penalties and Liquidated Damages under the Law of the Republic of Lithuania

In today's commercial world contracts are being bargained and concluded between parties from different countries. Even when parties are from the same country, they are not restricted from the choice of law applicable to the contract. The chosen law may be applicable to the whole agreement or just part of it[1]. But what if parties include a clause, which is not regulated by the chosen law? For instance, commercial parties intentionally include liquidated damages for the breach of contract but choose the law of Lithuanian Republic to be applied to the contract, which neither explicitly establish nor prohibit the application of liquidated damages.

Within the CC we cannot find any identical legal instrument to match liquidated damages. The Article 6.256(2) of the CC only provides for a liability to compensate damages and/or pay penalty (fine, interest). Precisely the latter (penalty) in a way may be viewed as a substitute for liquidated damages under the law of Lithuanian Republic, since it also fixes an exact amount payable upon the breach of contract and does not require any proof of loss. Both liquidated damages and penalties are of accessory nature and, in general, are only payable due to the liability for non-performance or defective performance of the contractual obligation. There are similar exceptions to liability, for instance, the breached obligation is void, or there is a sufficient defense for non-performance, such as force majeure or absence of fault, etc. The Article 6.258(2) of the CC provides that in cases where the penalty is payable for the delay in performance, the creditor is entitled to both penalty and performance. Similar rules concerning delayed performance apply under the common law in respect of liquidated damages.

Liquidated damages and penalties may be distinguished by comparing the liability limitation rules, models of control over agreed sums and purpose of the clauses.

[1] Regulation (EC) No 593/2008 of the European Parliament and of the Council of 17 June 2008 on the law applicable to contractual obligations (Rome I). The Article 3(1).

Liquidated damages set a cap upon recoverable damages. In other words, a non-breaching party may only claim either agreed sum or damages determined by the court, but is not entitled to both, even if that ensures a full compensation. So liquidated damages function as the limitation of liability, whereas penalties under the law of Lithuanian Republic are regulated contrarily. The principle established in the Article 6.251 of the CC ensures the compensation of damages in full and entitles the non-breaching party to claim both penalty and compensation of damages at the same time (the Article 6.258(2) of the CC). In such cases courts grant the amount that is greater, since it is considered to include the smaller one as well[1]. Parties may, for instance, include exclusive penalty, as the only payable amount for the breach (Lazauskaitė, 2010), but certain exceptions, such as the debtor's intentional fault or gross negligence, would still apply to that agreement (the Article 6.252 of the CC).

Both legal systems establish a particular model of control over agreed sums payable upon the breach. If a penalty is unreasonably excessive, courts of Lithuanian Republic are allowed to intervene and reduce it in accordance with the Article 6.258(3) of the CC and case law that establishes certain criteria to justify the reduction[2], whereas common law courts are not granted with the power to reduce the amount of liquidated damages but may render the clause unenforceable. Neither model of control permits to increase the agreed amount, even if ludicrously small.

The comparative analysis of penalties and liquidated damages show mutual incompatibility. The distinct purposes may persuade of this assertion even more, e.g. liquidated damages are aimed at facilitating the compensation of damages, whereas penalties besides that, also secure the performance of contractual obligations. At first sight, the purpose of penalties alone is contrary to liquidated damages. Nevertheless, the Supreme Court of Lithuania[3] referred to the term of liquidated damages and, as Meškys (2012) observes, established liquidated damages as a separate form of security of obligations that falls under the Article 6.70(1) of the CC. Other scholars disagree with such position, mainly since securing performance and deterring the breach is against the traditional purpose of liquidated damages (Bublienė and Trukskaitė-Paškevičienė, 2013). However, from the modern point of view liquidated damages are integral with the commercial justification test. This means, as it was stated in the second chapter, liquidated damages agreed by commercial parties are enforceable, even when exceed genuinely pre-estimated loss, provided that deterrence of the breach is not the dominant purpose. So to this extent liquidated damages may function as the kind of security of obligations under the Article 6.70(1) of the CC. Let's assume this proposition is correct,

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[1] The Supreme Court of Lithuania, Civil Division, 16 May 2013 ruling in the civil case No. 3K-3-230/2013.

[2] The Supreme Court of Lithuania, Civil Division, 5 March 2007 ruling in the civil case No. 3K-3-85/2007; The Supreme Court of Lithuania, Civil Division, 15 May 2007 ruling in the civil case No. 3K-3-205/2007(S); the Supreme Court of Lithuania, Civil Division, 24 September 2007 ruling in the civil case No. 3K-3-338/2007; the Supreme Court of Lithuania, Civil Division, 1 October 2007 ruling in the civil case No. 3K-3-361/2007; the Supreme Court of Lithuania, Civil Division, 12 October 2007 ruling in the civil case No. 3K-3-304/2007.

[3] The Supreme Court of Lithuania, Civil Division, 6 November 2006 ruling in the civil case No. 3K-P-382/2006.

but then the question is to which form of liability liquidated damages should be attributed. According to the Article 6.256(2) of the CC, only penalty and compensation of damages are established as two possible forms of contractual liability. Undoubtedly, liquidated damages have more common hallmarks with penalties, rather than compensation of damages. So if parties intentionally include liquidated damages for the breach of contract but choose the law of Lithuanian Republic to be applied to the contract, based on the analogy of statute, rules that govern penalties would also govern liquidated damages (the Article 1.8(1) of the CC). This way the model of control applicable to liquidated damages would shift from voidance to reduction of agreed amounts, unless the legislative process separating liquidated damages from penalties as a separate form of liability and incorporating additional grounds for voiding agreed amounts takes place. Otherwise, there will be no other judicial tool available for courts of Lithuanian Republic to control unreasonably excessive amounts, rather than reducing them. The problem of accommodating rules of liability limitation applicable to liquidated damages would also have to be dealt with. Under the current regulation liquidated damages would not escape the application of Articles 6.251 and 6.252 of the CC, so they would only limit the liability to the extent same as, for instance, exclusive penalty.

Although the issue of accommodating the liability limitation rules applicable to liquidated damages requires a thorough analysis, especially in respect of protection of weaker parties, nevertheless, the focus of this article is on agreed amounts set by commercial parties that exceed anticipated or actual harm. As the recent case law indicate, common law courts become more and more reluctant in rendering liquidated damages unenforceable, however, commercial justification, based on the reasonableness of the agreed amount, rather than fairness of the contract process, seems unlikely to completely resolve the problem of legal uncertainty in contractual relationships. On the other hand, in Lithuanian Republic the stability of contractual relationships is damaged when courts reduce the sums of penalties defined in the commercial contracts without explaining why it has been decided not to take into consideration the commercial type of relationship or even without mentioning the fact that the parties are businessmen[1]. So it has to be further analyzed whether adopting a similar test to commercial justification applicable to penalties would enhance legal certainty and parties' autonomy in contractual relationships in Lithuanian Republic, or perhaps a more radical solution is required, such as establishing liquidated damages as a separate form of liability, with additional grounds for voiding the clause, based on the unreasonableness of the agreed amount and/or unfairness of the contract process.

Conclusions

Within the common law the traditional approach, in accordance of which the enforceability of liquidated damages rests upon the difficulty of proof of loss and

[1] The Supreme Court of Lithuania, Civil Division, 19 June 2006 ruling in the civil case No. 3K-3-409/2006; the Court of Appeal of Lithuania, 28 June 2012 ruling in the civil case No. 2A-1314.

disproportion of the agreed sum, compared to the anticipated or actual harm, is relatively rigid from the point of view of commercial contractors that seek for a legal instrument enabling to convey information about a party's intent or capability to perform under the contract. Recently adopted commercial justification test applicable to liquidated damages that exceed genuine pre-estimate of loss seems to resolve this problem to some extent, nevertheless, legal uncertainty in determining the lines between a valid liquidated damages clause and an invalid penalty will remain, as long as the focus is on the unreasonableness of the agreed amount, rather than unfairness of the contract process.

If parties intentionally include liquidated damages for the breach of contract but choose the law of Lithuanian Republic to be applied to the contract, then, in accordance with the analogy of statute, rules that govern penalties would govern liquidated damages. This way the model of control applicable to liquidated damages would shift from voidance to reduction of agreed amounts, unless the legislative process separating liquidated damages from penalties as a separate form of liability and incorporating additional grounds for voiding agreed amounts takes place.

In Lithuanian Republic the stability of contractual relationships is damaged when courts reduce the sums of penalties defined in the commercial contracts without explaining why it has been decided not to take into consideration the commercial type of relationship or even without mentioning the fact that the parties are businessmen. So further analysis is necessary in order to determine whether adopting a similar test to commercial justification applicable to penalties would enhance legal certainty and parties' autonomy in contractual relationships in Lithuanian Republic, or perhaps a more radical solution is required, such as establishing liquidated damages as a separate form of liability, with additional grounds for voiding the clause, based on the unreasonableness of the agreed amount and/or unfairness of the contract process.

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