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CONTRACTUAL PENALTY CLAUSES IN RECENT SERBIAN ARBITRATION PRACTICE*

The focus of the paper is on the analysis of different approaches to situation when the parties are allowed to agree on sums payable in the event of breach of obligations, issues pertaining to contractual penalties in general as well as practical and doctrinal differences in their compensatory and penal goal. The authors reflect on some of the acute issues raised in recent arbitral practice with respect to the topic of contractual penalties, particularly in the sphere of privatization agreements. One of the problems analyzed relates to characterization of the secured obligations in privatizations, reductions of penalties as well as the issue of combining contractual penalties with bank guarantees and with the prohibition of restitution contained in the Law on Privatization of the Republic of Serbia.

Key words: *Contractual penalties. Privatization Agreements. Non performance. Delay. Proportionality principle.*

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1. ON CONTRACTUAL PENALTY CLAUSES IN GENERAL

Contractual penalty clause represents a *legal remedy*¹ frequently agreed upon for breach of contractual obligations. The variety of terms used to describe it (*legal remedy, contractual penalty, agreed sum*) reflects its polyvalent and difficult to define legal nature.²

Scholarly writing often highlights the variety of *functions* this institute has (or ought to have) across various legal traditions and systems. The attempts to describe legal nature of the penalty clauses thus often end up intertwined with its functional analysis.

It is often submitted that the contractual penalty serves to secure performance of an obligation.³ However, it is seldom listed as one of the means employed to secure one's claims,⁴ be they *in rem*⁵ or *in perso-*

¹ See: Mihailo Konstantinović, "Priroda ugovorne kazne Smanjenje od strane suda", Anali Pravnog fakulteta Univerziteta u Beogradu 2/1953, re published in 3 4/1982, 523 524 (page references are given by the 1982 edition). For contemporary practice in Serbia cf. Gordana Ajnšpiler Popović, "Ugovorna kazna", *Pravni informator* 3/2006, 3. For "the major role in practice" in Swiss law see e.g. Pierre Tercier, *Le droit des obligations*, Schulthess Verlag, Zurich 2009⁴, 281. For French and Belgian practice see Patrick Wéry, "La clause pénale", *Les clauses applicables en cas d'inexécution des obligations contractuelles* (ed. Patrick Wéry), La Chartre, Brussels 2001, 1, to the extent that the contractual penalty clauses represent "a standard feature of commercial contracts in all areas of business, which gives them great practical importance" see Pascal Hachem, *Agreed Sums Payable upon Breach of an Obligation, Rethinking Penalty and Liquidated Damages Clauses*, Eleven International Publishing, Den Haag 2010, 18. The author bases this remark on comparative analysis. See also Petar Miladin, "Odnos između ugovorne kazne i srodnih klauzula", *Zbornik Pravnog fakulteta u Zagrebu* 56/2006, 1762 1763. The author invokes the Report of the Working Group *Contrats internationaux* within the UNCTRAL. See also Milena Đorđević, *Obim naknade štete zbog povrede ugovora o međunarodnoj prodaji robe*, doctoral thesis, Belgrade 2012, 259 with numerous references cited therein.

² P. Wéry, 1; Hachem, 18.

³ See Denis Mazeaud, *La notion de clause pénale*, LGDJ, Paris, 1992, 87. Cf. Philippe Malinvaud, *Droit des obligations*, Litec, Paris 2007¹⁰, 311, for contractual penalty as a means of securing the performance of an obligation (as well). "Contractual penalty represent a means of securing the performance and of execution of a contract" Supreme Court of Serbia, Rev. 1482/92. Cf. Art. 272(1) of the Law on Contracts and Torts: "A penalty clause shall share the legal fate of the obligation it secures."

⁴ Cf. P. Hachem, 43 44, stating that Roman Law treated agreed sum payable upon breach of obligation as a means of securing performance and that it is not just Code Civil, but other codifications as well (at least implicitly) take the same position, putting economic pressure on debtor to perform obligation..

⁵ Contractual penalty is not *in rem* means of securing performance since it does not establish "*in rem* right which will empower the creditor to encash its obligation out of the value of the object of property" (see Nikola Gavella, *Stvarno pravo*, Narodne novine, Zagreb 2007¹¹, vol. 2, 10), it does not "allow creditor to encash its claim out of a particular object of property in case debtor fails to settle the debt out of its general property" (see Andreja Gams, *Stvarno pravo*, Naučna knjiga, Belgrade 1971^{VI}, 179). With respect to the

*nam*⁶. This is because contractual penalty pressures debtor to stay true to the obligations it has undertaken. Given that it is due only if there was no performance or performance was late, it performs its function as a means of security in an indirect manner.⁷

Its analysis inevitably starts with its statutory definitions. Contractual penalty clause represents an agreed upon sum or another material benefit a debtor owes to the creditor if he fails to fulfill his obligation or is late in fulfilling it.⁸

This general notion highlights its following elements and functions:

- (1) although usually physically inserted in the contract, agreement on contractual penalty clause represents a separate agreement, its validity is examined separately from the validity of the contract in which it is contained;⁹
- (2) at the same time, this is an accessory agreement, and it shares legal fate of the obligation it is supposed to secure.¹⁰ Article

amount or the good which forms the object of contractual penalty, the creditor does not have the right of priority nor *droit de suite*.

⁶ See in that sense e.g. Jakov Radišić, *Obligaciono pravo, opšti deo* [Law of obligations, general part], Nomos, Belgrade 2004⁷, 318. See *contra*, for exclusion of contractual penalty from the scope of *in personam* means of securing the performance Michel Cabrillac, Christian Mouly, Séverine Cabrillac, Philippe Pétel, *Droit des sûretés*, Litec, Paris 2010⁹, 37 39. Unlike the usual *in personam* means of securing obligation, contractual penalty does not involve other actors (as providing a bank guarantee or suretyship does).

⁷ See D. Mazeaud, 87. It always serves to “discipline” the debtor, as stated by Stojan Cigoj, *Komentar obligacijskih razmerij*, Uradni List SRS, Ljubljana, 1984, vol. II, 966. for securing the performance by pressure in Swiss law see P. Tercier, 281. Cf. Henri Mazeaud, Léon Mazeaud, Jean Mazeaud, François Chabas, *Leçons de droit civil*, tome II, premier volume, Montchrestien, Paris 1978^{VI}, 991 1000.

⁸ See Art. 270(1) of the Serbian Law on Contracts and Torts (hereinafter: LCT). Cf. § 339 345 of the German Civil Code (hereinafter: BGB), Arts. 160 163 of the Swiss Law on Obligations, Art. 1152 of the French Civil Code (hereinafter: CC), Art. 333 of the Civil Code of the Russian Federation, § 1382 of the Italian Civil Code. International sources of unified or harmonized contract law also contain provisions on contractual penalty. See e.g. Art. 7.4.13 of the UNIDROIT Principles of International Commercial Contracts, 2010, Art. 9:509 of the Principles of European Contract Law, 2002.

⁹ See P. Wéry, 4, Dragan Pavić, “Sudska kontrola ugovorne kazne, *Pravni život* 10/2000, 396. It does not matter whether it is a separate agreement or a clause inserted into the main contract.

¹⁰ See Art. 272(1) LCT. Cf. S. Cigoj, 969 970. See also P. Tercier, 280. Cf. for the relative effect of the rules on accessory character, D. Mazeaud, 13 et seq. See also D. Pavić, 396 397, stressing that the accessory character is not contradictory with the position that its validity is examined separately. Consequently, it does not represent a non essential element of the contract within the meaning of Art. 32(2) LCT and can not therefore be later regulated by court. See for the contradicting conceptions on the scope of Art. 32(2) in Serbian

220 of the Draft of the Code of Contracts and Obligations¹¹ provided for so-called *independent penal promise*¹², i.e. independent promise to pay a sum of money if the ‘promissor does something or fails to do something’. This was omitted from the Law on Contracts and Torts (hereinafter: LCT). Pursuant to the principle of the freedom of contracting, such promise may still be stipulated, but will be subject to the legal regime applicable to the contractual penalty clause;

- (3) it has to be agreed upon in advance, for possible future breach of contractual obligation. If that is not the case, the parties are actually agreeing on liquidating damages which have already occurred¹³. Commentators seldom highlight this, as it is presumed that the parties can fix or limit damages *in advance*.¹⁴
- (4) contractual penalty is stipulated for cases when debtor fails to act in accordance with his contractual obligation, either because he fails to perform it on time, or fails to perform it altogether. Pursuant to LCT, penalty clause is presumed to have been stipulated for cases of late performance, unless it explicitly covers non-performance.¹⁵

Penalties are due for non-performance or for defective performance.¹⁶ Serbian law provides for evidently different solutions on certain issues when it comes to contractual penalties for non-performance, on one hand, and late performance, on the other. For instance, cumulating performance and penalty sum is possible when it comes to late performance, but not when it comes to non-performance.¹⁷ However, potentially different

legal doctrine, Miloš Živković, *Obim saglasnosti neophodan za zaključenje ugovora*, Belgrade 2006, 184–186. See also Guenter Heinz Treitel, *Remedies for Breach of Contract, a comparative account*, Oxford University Press, Oxford 1988, 213–214.

¹¹ Mihailo Konstantinović, *Obligacije i ugovori – skica za zakonik o obligacijama i ugovorima*, Belgrade 1969, Art. 220, Cf. § 343(2) BGB.

¹² See P. Miladin, 1763. Cf. G.H. Treitel, 209–210, uses the term *independent penal promise*.

¹³ See S. Cigoj, 965.

¹⁴ See D. Mazeaud, 297, Philippe Delebecque, Frédéric Jérôme Pansier, *Droit des obligations, Contrat et quasi contrat*, Litec, Paris 2010⁵, 310.

¹⁵ See Art. 270(1) and (2) LCT.

¹⁶ General usages for trade of goods, *Official Gazette of the Federal People's Republic of Yugoslavia* 15/54, in Art. 245, provided for contractual penalty for non performance or defective performance, as well e.g. as Art. 339 BGB and Art. 160 of the Swiss Code of Obligations. Code civil, Art. 1382 refers to non performance. For a possible distinction between the two notions, see S. Cigoj, 973, Zvonimir Slakoper, Vilim Gorenc, *Obvezno pravo, opći dio*, Novi informator, Zagreb 2009, 253.

¹⁷ See Art. 273 LCT.

terms and expressions used in comparative legislation do not necessarily result in divergent scope of application of this legal institution.

Admittedly, it is possible to distinguish between non-performance (where a debtor does not perform at all) from a defective or late performance of a contractual obligation. However, the notion of a 'contractual obligation' is a complex one. A contract often burdens each of the parties with more than one obligation to fulfill. Sometimes, they are not interrelated, on other occasions they are – and performance of one is dependent on performance of another. Non-performance usually means that a party has failed to perform its principal obligation, or several of such principal obligations, as may be the case. French law refers to this situation as *in-exécution grave*¹⁸. However, non-performance might also occur where a party only *partially* fulfills an obligation of *fundamental* importance. In other words, 'non-performance' represents a notion that might cover even situations where there has been a performance – a defective one.

The general notion of 'legal remedy' and the above listed elements represent a starting point for analysis of two of its essential functions: compensatory¹⁹ and penal.

Contractual penalty clause is usually regarded as a vehicle for a creditor to be reimbursed for damages he suffered due to non-performance, late or defective performance. Agreeing upon a sum to be paid in advance strengthens the position of the creditor, as it relieves him of the burden of proving the existence of damages or its extent.²⁰ This is why scholars insist on drawing a distinction between a contractual penalty clause and a clause limiting one's liability.²¹ This compensatory function is often a reference point around which national legislation develops its position on whether and to what extent contractual penalty might be collected alongside contractual damages.²²

On the other hand, where a penalty clause is agreed upon in order to put pressure on debtor, 'disciplining' him and securing performance²³,

¹⁸ See Philippe Malaurie, Laurent Aynès, Philippe Stoffel Munck, *Droit civil, Les Obligations*, L.G.D.J., Paris 2009⁴, 457 458.

¹⁹ On contractual penalty as predominantly means to agree in advance upon contractual damages see P. Malaurie, L. Aynès, P. Stoffel Munck, 540, P. Malinvaud, 527, P. Delebecque, F J Pansier, 310. For a somewhat different position, on difference between contractual penalties and the the agreement on contractual damages in advance, see D. Mazeaud, 141 et seq.

²⁰ See M. Konstantinović (1982), 524, who adds that the burden of proof is allocated in such way as to require from the debtor to prove that the penalty is excessive if he wants to be granted reduction of the penalty. See also P. Hachem, 45.

²¹ See D. Mazeaud, 143 144 and references cited therein, P. Hachem, 47.

²² See G. H. Treitel, 217 219.

²³ See S. Cigoj, 966. See also P. Tercier, 281.

it loses most of its compensatory function and acquires penal characteristics. Doctrine often regards penalty for late performance as one having predominantly penal character, unlike penalty clause for non-performance which is predominantly of compensatory nature.²⁴ Penal nature of the clause often invokes comparisons to common law treatment of ‘penalties’ judge-made *clause d’astreinte* in French law.²⁵

Interplay and distinction between compensatory and penal functions is also reflected in the distinction common law makes between liquidated damages and penalties.²⁶ It is also possible to distinguish sub-functions within two main functions.²⁷ Irrespective of such nuances, contractual penalty clauses owe their popularity to their perceived usefulness, and consequently often find their way into contracts.²⁸ At the same time, their sweeping scope opens the door not only for use, but also for abuse,²⁹ and it may be deployed as a screen for loan sharks, or exploitation of debtor’s pressing needs, poor judgment or inexperience.³⁰ Abuses are normally curbed through general principles of contract law. However,

²⁴ See D. Pavić, 397, S. Cigoj, 965. With respect to the possibility of cumulating the performance and the penalty for delay see P. Malaurie, L. Aynès, P. Stoffel Munck, 540. For comparison of systems see P. Hachem, 35–38.

²⁵ See D. Mazeaud, 342–348 who points out the difference with respect to contractual penalty that stems from the fact that the latter has (also) the compensatory character. In the similar sense see P. Delebecque, F. J. Pansier, 310. See also D. Pavić, 297. Pavić compares this kind of contractual penalty to the penalties referred to in Art. 294 LCT. For *clause d’astreinte* and the difference with respect to contractual penalty, i.e. the difference between contractual penalty and penalties see P. Malinvaud, 527.

²⁶ See S. Cigoj, 965. Cf. Mirko Vasiljević, *Poslovno pravo*, Udruženje pravnik au privredi SRJ, Belgrade 2001, 651–652. This author compares the concept of contractual penalty (as codified by Special usages for construction business, *Official Gazette of the Socialist Federal Republic of Yugoslavia* 18/77) with the compromise between the Civil and common law divide reflected in 1983 UNCITRAL Uniform Rules on Contract Clauses for an Agreed Sum Due upon failure of Performance. On the notion of liquidated damages (distinguished from penalties) see Michael P. Furmston, *Cheshire, Fifoot and Furmston’s Law of Contract*, Oxford University Press, Oxford 2001¹⁴, 688 et seq, Guenther Heinz Treitel, *The Law of Contract*, Swet and Maxwell, London 1991⁸, 883 et seq. Common law jurisdictions clearly distinguish between penal and compensatory mechanisms for breach of contractual obligation, while the civil law systems usually combine the two.

²⁷ See D. Pavić, 397–398. The author addresses four different types of agreement which fall under the generic notion of ‘contractual penalty’. In Serbian legal doctrine see Adam Vass, “Ugovorna (konvencionalna) kazna”, *Glasnik advokatske komore Vojvodine*, 7–8/1979, 29. S. Cigoj, 965, who makes a distinction between the penalty due no matter whether the creditor suffered damage, and the penalty aimed at liquidating damages. For a triple legal nature of penalty see P. Malaurie, L. Aynès, P. Stoffel Munck, 540.

²⁸ See M. Konstantinović (1982), 523–524.

²⁹ For prevention of abuse see D. Pavić, 394. and references cited therein. For abuse of economic position when contracting see P. Malinvaud, 223.

³⁰ See M. Konstantinović (1982), 524.

many legal systems considered them to be inadequate and introduced specific mechanisms³¹ as protection from abusive contractual penalties: fixing or limiting their value,³² or allowing the court to reduce the excessive sum on its own motion or at the request of the debtor.³³

Popularity and frequent use of contractual penalties in commercial practice raise important and numerous issues, value of the agreed sum being just one of them. Some issues have frequently arisen in Serbian arbitral practice, especially in the context of privatization agreements. Given the paucity of reports of arbitral practice in general, and Serbian arbitral practice in particular, analyzing and publicizing recent arbitral practice on penalty clauses might be of interest, and not only to arbitration practitioners. Classification of the issues analyzed is relatively loose and does not necessarily adhere to precise systematization – this was to a certain extent an inevitable consequence of the heterogeneous nature of the issues which had arisen.

2. BREACH OF CONTRACT, THE RIGHT TO CONTRACTUAL PENALTY AND OTHER LEGAL REMEDIES IN CASE OF NON-PERFORMANCE

As outlined above, contractual penalties might be agreed to cover late performance or non-performance (including partial or defective performance). The agreement has to specify the breach covered. In Serbian law, absent such specification it will be assumed that the penalty was agreed for late performance.³⁴

³¹ For the so called *clauses abusives* and protection therefrom, see P. Malinvaud, 223 et seq.

³² See P. Hachem, 55 56, listing certain jurisdictions in South America (Brazil, Mexico, Bolivia, etc.) and Europe (Portugal). In Serbian law, see Special usages for construction business, M. Vasiljević, 651 652. See also S. Cigoj, 968. For the possibility of application of Art. 601(a) of the 1844 Serbian Civil Code (which limits all sorts of penalties (“*hasna*”), irrespective of their name) to contractual penalty, see Radmila Rakočević, *Ugovorna kazna u poslovima prometa robe i usluga*, master thesis, unpublished, Faculty of Law, University of Belgrade, 1981.

³³ See Art. 274 LCT. Swiss Code of Obligations in Art. 163(3) provides that the court “may reduce penalties that it considers excessive”. Art. 343 BGB requires from the court to take into consideration every interest of a creditor’s and not just the pecuniary one, when reducing the amount of the penalty. Art. 1152 CC in its 1985 version authorizes the judge to modify the amount of the penalty even in absence of a motion from the parties, and the 1975 version provided for modification if the agreed upon sum was excessively high or excessively low. National legislation does not clarify what is to be compared with the agreed upon sum when deciding on reduction, see G.H. Treitel (1988), 224.

³⁴ See Art. 270(1) LCT.

2.1. Non-performance and penalty clause

It is worth repeating that a contract often gives rise to several different and possibly interrelated obligations. Where the penalty has been agreed for breaching only some (or one) of them, penalty will be due only if the actual breach qualifies as the type of breach (non-performance, late performance) envisaged in the penalty clause. This gives rise to the problem of qualification (characterization), especially in the context of late or partial performance.

The parties might also provide different penalties to secure different obligations. Arbitration practice provides examples of such approach, especially in the context of privatization agreements. The tribunals were unison in finding that, in order to claim the penalty it is sufficient (and necessary, at the same time) that a particular obligation was breached. They also held that cumulation of penalties is possible where several obligations were breached.³⁵ On the other hand, it was held that penalty is not due where it does not cover a particular (breached) obligation in question,³⁶ even though it covers other similar obligations.

Tribunals did not have to directly address whether partial non-performance triggers obligation to pay the penalty, or whether the fact that it is partial is to be regarded in the context of reducing the agreed sum.³⁷

2.2. Debtor's fault

The cases analyzed seldom turned on the legal notion of non-performance. Instead, the parties usually disputed whether the breach occurred as a matter of fact. However, in certain cases the issue was whether debtor's fault (in failing to perform or performing late) is of relevance. Namely, the respondents argued that the breach was not due to any fault on their side.³⁸

³⁵ FTCA Final Award in the case no T 12/10 of 19 September 2012, FTCA Award in the case no T 14/11 of 13 March 2013, FTCA Final Award in the case no T 7/09 of 27 April 2012, FTCA Final Award in the case no T 9/10 of 10 October 2011.

³⁶ In one of the cases the tribunal refused to order payment of penalties for breach of obligations which was not explicitly secured by penalties, and rejected claimant's 'systematic interpretation of the contract', observing that 'had the parties wished to do so, they could have done so clearly just like they did with respect to certain other contractual provisions' FTCA Award in the case no T 14/11 of 13 March 2013.

³⁷ See Art. 253 of General Usages, which provides that the contractual penalty is to be calculated against the entire value of the obligation until such time that it is performed partially, and after the time of the partial performance only for the value of the yet unfulfilled part of the obligation. If there is more than one obligation secured by penalty, it is calculated for each of them separately and proportionally to their value.

³⁸ FTCA Award in the case no T 14/11 of 13 March 2013, FTCA Final Award in the case no T 9/10 of 10 October 2011, FTCA Final Award in the case no T 12/10 of 19 September 2012.

LCT provides that the penalty clause ceases to have effect if non-performance or delay is a consequence of something for which the debtor is not liable.³⁹ However, the purpose of this provision is not to introduce fault of the debtor as a prerequisite for its obligation to pay contractual penalty. “Debtor’s default is sufficient to entitle creditor to contractual penalty.”⁴⁰

It should be also borne in mind that Serbian law adheres to objective notion of default – debtor’s fault is not a necessary precondition for default.⁴¹ Reasons for non-performance or late performance might become relevant only in context of certain consequences of default: liability for damages and the risk for subsequent impossibility to perform.⁴² This is a key for understanding the wording used by the legislator when referring to “something for which the debtor is not liable”: LCT absolves debtor from its liability for damages if the non-performance is due to event that it could not have prevented, overcome or avoid⁴³ or if failure to perform is due to creditor’s fault⁴⁴.

Only in one of the analyzed cases debtor claimed that non-performance was due to workers’ strike in the privatized company, and qualified that the labor strike amounted to *vis maior*. The tribunal rejected this argument, stating that Serbian courts are almost unison in their view that labor strikes cannot be considered *vis maior*.⁴⁵

More often, the debtors (respondents) have argued that it was not them, but the creditors (claimants) who were at fault, that they have rescinded contracts without the proper cause (non-performance)⁴⁶ and claimed that this entitles them (debtors) to compensation for damages.⁴⁷ Privatization buyers regularly claimed that the presented data of the companies was incomplete and incorrect,⁴⁸ and argued that this made sellers’ performance faulty, both substantively and legally. These arguments were

³⁹ See Art. 272(2) LCT. When stating this precondition, the domestic doctrine does not focus on its meaning and scope.

⁴⁰ See M. Konstantinović (1982), 521.

⁴¹ See Art. 324 LCT.

⁴² See J. Radišić, 330 332.

⁴³ See Art. 263 LCT.

⁴⁴ See Art. 265 LCT. Both cases refer to preconditions which do not exclude the obligation to compensate for the contractual damage, which reminds of the predominantly reparatory character of contractual penalty.

⁴⁵ FTCA Final Award in the case no T 9/10 of 10 October 2011

⁴⁶ FTCA Award in the case no T 14/11 of 13 March 2013, FTCA Final Award in the case no T 9/10 of 10 October 2011, FTCA Final Award in the case no T 12/10 of 19 September 2012.

⁴⁷ FTCA Final Award in the case no T 9/10 of 10 October 2011

⁴⁸ FTCA Final Award in the case no T 9/10 of 10 October 2011, FTCA Final Award in the case no T 12/10 of 19 September 2012.

rejected in all cases, since all of the buyers have failed to raise these points on time, and given that said shortcomings *affected contract conclusion, rather than its performance*, or any fault of the seller thereof.

Less often, debtors claimed that sellers' actions after conclusion of the caused non-performance. The usual argument was that a seller failed to perform one of his obligations and that this had, in turn, made debtor's performance impossible or at least significantly more difficult. Given that those allegations were either not supported by the facts, or not firmly based in the contract, the tribunals did not have to delve into their legal aspect.⁴⁹

2.3. Delay (late performance)

Although seemingly non-controversial, the notion of delay became less so in the context of contractual penalty in one of the cases.⁵⁰ Delay represents a period of time passed since the default, in which the debtor has failed to perform its obligation. Contractual penalty is also agreed as a certain sum (or percentage of the contracted price) per unit of time.⁵¹ Since the delay starts running at the time of the default, and ceases to run at the time of the performance, its length will be unquestionable only after the obligation is performed. Delay is therefore a *period* between those two points in time.

If delay is indeed a period between defaulting and performing, one could argue that there has to be eventual performance in order to distinguish delay from non-performance (complete failure to perform). This would suggest that a creditor cannot claim penalty for delay if debtor has not yet performed. In such case, there has been no performance, rather than late performance. Also, if creditor avoids the contract, it will lose the right to seek contractual penalty for delay.⁵²

It is possible to approach this issue in a different way. Namely, although the primary function of the penalty for delay is to press debtor into performing on time (or, at least, to incite it to keep the delay as short as possible), it is also of compensatory nature. Collecting what is due on the basis of delay, while still expecting the contract to be performed would

⁴⁹ In one of the analyzed cases, the debtor claimed that, although the State offered it a loan with below market interest rate to settle its obligations, it was also asked for a collateral it (the debtor) did not deem suitable (!) (FTCA Award in the case no T 14/11 of 13 March 2013); in another the debtor claimed that the State did provide benefits that would have been appropriate in the light of the worldwide economic crisis, pursuant to the conclusions and adopted by the Government (FTCA Final Award in the case no T 12/10 of 19 September 2012). In the third case, it was established that the creditor did what is was expected to do, and cooperated with the debtor with respect to debtor's fulfillment of its contractual obligations (Ad hoc Final Award of 1 April 2013).

⁵⁰ Ad hoc Final Award of 1 April 2013.

⁵¹ See Art. 271(1) LCT.

⁵² This is confirmed in case law. See G. Ajnšpiler Popović, 12.

therefore be possible, subject to certain limitations. In one of the analyzed awards contractual penalty for delay was given although there was no performance until that point in time.⁵³ Penalty for delay was set as a fixed sum per time unit. Debtor defaulted and the creditor sought penalty for the period that has elapsed since the default, but also for any future delay, until performance. The beginning of the period for penalty calculation (time of default) was not contested, nor did the parties contest that the debtor would perform its obligation at some future point in time. The tribunal held that the creditor was entitled to penalty for the period that had already elapsed, but that it was, at the time, not entitled to penalty for delay that might occur in the future (after the date of the award). To hold otherwise would mean that the tribunal would not be able to apply the principle of proportionality, and would be prevented from contemplating reduction of the amount of penalty. Both of those actions presuppose that the tribunal already knows the exact sum due pursuant to the contracted calculation, and no such certainty exists for future, open-ended period of delay.⁵⁴

2.4. Avoidance, certain consequences of avoidance and the obligation to pay contractual penalty

Where both parties owe something pursuant to the contract, and it is certain that the contract will not be performed, one can expect the contract to be avoided. LCT provides that “avoidance releases both parties from their obligations, save for obligation to compensate the other party for subsequent loss.”⁵⁵ Arbitral practice was confronted with the issue of whether ‘release from obligations’ also meant releasing from an obligation to pay contractual penalty.

Creditor who has avoided the contract should certainly be able to collect the penalty agreed upon for the case of *non-performance*. Contractual penalty is also of compensatory nature. Creditor is entitled to be compensated for damages suffered, and to benefit from not having to prove damages if they do not exceed the amount of penalty.

If it were otherwise, creditor would face a choice: either to avoid and forfeit all the benefits of the contractual penalty clause, or collect the

⁵³ See Dragor Hiber, “Ugovorna kazna I buduće zadocnjenje u izvršenju obaveze”, *Razvoj pravnog sistema Srbije I harmonizacija sa pravom EU* (eds. Radmila Vasić, Ivana Krstić), Pravni fakultet Univerziteta u Beogradu, Belgrade 2013, 341 356.

⁵⁴ This particular issue sheds a new light on the earlier discussions over the wording of the LCT in doctrine. When laying out potential triggers for contractual penalty, LCT distinguishes between non performance (failure to perform) and delay. On the other hand, General usages on trade in goods provided for non performance or defective performance (*neuredno ispunjenje*) as triggers (this was the solution supported by Cigoj, 967. The use of ‘defective performance’ would encompass delay as well, but would make it clear that, when not contracted for case of non performance, contractual penalty could be claimed only if there *was* actual performance.

⁵⁵ See Art. 132(1) LCT.

clause and forfeit what he would be due as a consequence of avoidance (e.g. restitution, cessation of his own obligation towards debtor, etc.). This outcome would be illogical and impractical.

If one can avoid the contract *and* still be entitled to penalty, this still leaves open issues concerning the availability of other rights parties have in case of avoidance. Two of such issues arose in the analyzed awards.

One stemmed from a particular provision of Serbian Privatization Law. Art. 51a of this Law deprives buyer from his rights in case of restitution – if the contract is avoided a buyer will not be returned purchase price. Three tribunals addressed this provision, and its interplay with contractual penalty clauses.⁵⁶

In one of the cases the debtor argued that the said provision is incompatible with the contractual penalty, since both lead to the same outcome. The tribunal, however, held that there are significant differences between the two. Excluding or limiting restitution is used at times, primarily to prevent a party acting in bad faith to profit from termination of contractual obligations. *Nemo auditur propriam turpitudinem allegans* maxim and its progeny (e.g. Art. 104(2) LCT) have much the same goal.⁵⁷ The only possible overlap with contractual penalty might be the provision of the LCT clarifying that one cannot claim *both* a contractual penalty and a “penalty, contractual penalty or the like” provided by the statute itself.⁵⁸ The tribunal held that prohibition of restitution is not of penal character, and that it does not oblige debtor to give anything to creditor.⁵⁹ Consequently, it was held that seller can collect contractual penalty, pursuant to contract, and keep the contractual price, pursuant to the Law on Privatization.

Another controversial issue was the relationship between contractual penalty and first demand bank guarantee. Debtors submitted that one cannot claim payment pursuant to both at the same time, and that one may request return of the sum paid under guarantee if the contract was terminated or if the contractual penalty has been collected.

Bank guarantees and contractual penalties often serve to strengthen the position of creditor.⁶⁰ Failure to perform as agreed entitles creditor to

⁵⁶ FTCA Final Award in the case no T 9/10 of 10 October 2011, FTCA Award in the case no T 14/11 of 13 March 2013, FTCA Final Award in the case no T 12/10 of 19 September 2012.

⁵⁷ See Slobodan Perović, *Obligaciono pravo*, Službeni list SFRJ, Belgrade 1990⁷, 457 and 468. For immoral contracts see P. Malinvaud, 197–198.

⁵⁸ See Art. 276 LCT.

⁵⁹ FTCA Final Award in the case no T 9/10 of 10 October 2011.

⁶⁰ See fn 1 above. For the history of extension of application of bank guarantees in modern law, see Branko Vukmir, “Razlozi za obustavu isplate bankarskih garancija na

compensation out of bank guarantee (in which case the payment will be effected by the bank) or pursuant to contractual penalty clause (lump sum agreed upon in advance). Just like contractual penalty, bank guarantee is also open to abuse: “a first demand bank guarantee can (...) be turned into a merciless weapon, leading to unjust results”⁶¹ .

The analyzed awards often allowed for cumulation of sums pursuant to bank guarantees and contractual penalties, and the matter was normally not raised by any of the parties. When the matter was finally raised by the parties, the outcome was the same.⁶² (It is interesting to note, however, that the creditor relied on previous arbitral practice in Serbia, arguing that the legal issue is evidently regarded as settled.⁶³) Awards to the contrary have been reported in other jurisdictions, although it is unclear whether they have rejected cumulation as a matter of principle, or on the basis of particular facts.⁶⁴

Where a penalty clause provides for lump sum (*fr. forfaitaire*) compensation, its compensatory function can overlap or mirror that of the bank guarantee. Bank guarantee, even one on first demand, is ultimately a form of suretyship, and presupposes two obligations owed by the debtor: the primary one, and the secondary obligation to compensate for damages arising from the breach of the primary obligation.⁶⁵ On the other hand, bank’s obligation is abstract and independent,⁶⁶ and this overshadows the existence of obligation between the beneficiary of the guarantee and the bank: all creditor has to do is make it probable that the cause for which the guarantee was issued has been met, and the grounds on which payment may be refused are very limited.⁶⁷ The issue of cumulation may also arise later, in an entirely different context, where debtor requests the

poziv”, *Liber amicorum Jakša Barbić* (eds. Zoran Parać et al.), Pravni fakultet Sveučilišta u Zagrebu, Zagreb 2006, 238 239.

⁶¹ See Henri Capitant, François Terré, Yves Lequette, *Les grands arrêts de la jurisprudence civile*, Dalloz, Paris 2008¹², 859.

⁶² FTCA Award in the case no T 14/11 of 13 March 2013.

⁶³ (FTCA Award in the case no T 14/11 of 13 March 2013). Claimant relied on previous practice in cases decided before the FTCA tribunals. The tribunal reached a split decision, the majority found that the parties expressly provided in their agreement for possible cumulation of the sums under the contractual penalty and the bank guarantee. Reference to this award throughout this article will represent a reference to the opinion of the majority in the tribunal.

⁶⁴ ICC case no 5634/1988 as cited by Dominique Hacher, *Collection of ICC Arbitral Awards 1991 1995*, Paris, New York, 533, ICC 5721/1990. One additional, unreported, Serbian award ICC case no 13798/ 2007 also took this position.

⁶⁵ See P. Miladin, 1774 1775.

⁶⁶ See M. Cabrillac, C. Mouly, S. Cabrillac, P. Petel, 350 360 and 376 379.

⁶⁷ See Roeland. I.V.F. Bertrams, *Bank Guarantees in International Trade*, Kluwer Law International, 2004³, 48 50. See also the judgment of the Higher Commercial Court in Belgrade, Pž. no. 3520/95.

return of the guarantee. Bank's relationship towards beneficiary and debtor's relationship with the bank are both abstract and independent. Bank cannot invoke objections that a debtor might have against beneficiary, objections stemming from their mutual relationship. Likewise, debtor lacks leverage to prevent the bank from paying out once the mechanism has been set in motion. That is why a debtor can ultimately seek from creditor (beneficiary of the bank guarantee) what he would not have been entitled to collect under the guarantee had the bank been entitled to invoke objections stemming from the contract between the debtor and the creditor.⁶⁸

The tribunal was split on this issue. The majority held that, pursuant to Art 1087 (3) LCT it was up to the debtor to prove that was no claim secured by the guarantee. Dissenting arbitrator opined that, although the objection was raised by the debtor, the burden of proof was on the beneficiary (creditor).

In any event, the tribunal held that, although abstract, bank guarantee loses such quality in a relationship between creditor (beneficiary of the guarantee) and debtor: "If one could collect pursuant to guarantee irrespective of whether any damages were suffered and what their extent was, or irrespective of the amount of some other claim stemming from the breach of contract, bank guarantee would cease to secure obligation and would instead acquire a penal character, or become an abstract obligation. Respondent/Counterclaimant is, therefore, correct when asserting that encashment of a bank guarantee presupposes existence of creditor's claim (...)." ⁶⁹ Given that Serbian law allows for a limited cumulation of contractual penalty and compensation for damages, one could also combine sums due to contractual penalty with sums due pursuant to bank guarantee, for the amount of damages exceeding the sum of contractual penalties.⁷⁰

3. AMOUNT DUE AND THE PRINCIPLE OF PROPORTIONALITY (APPROPRIATENESS)

The issue which arose most frequently in practice was reduction of the penalty sum.

⁶⁸ See Art. 1087 LCT. The assets received on the basis of a guarantee have the character of a deposit (see H. Capitant, F. Terré, Y. Lequette, 860), which precedes the determination of the amount, either by court or by the parties themselves, to be given to the beneficiary in conformity with the amount claimed. See Michel Cabrillac, Christian Mouly, *Droit des sûretés*, Litec, Paris 1999³, 348 (this reference to an earlier edition of the book referred to in fn. 6 is cited here on the basis of reference provided in the opinion of the dissenting arbitrator).

⁶⁹ Excerpt from the award. The opinion of the panel and the dissenting opinion differ with respect to the question of whether the damage has been proved.

⁷⁰ *Ibid.*

Contractual penalty is often compared to interest running on pecuniary obligations.⁷¹ Both can be contracted for in order to obfuscate debtor's predicament, inexperience or lack of viable alternatives.⁷² This can, of course, be curbed through application of regular tools of contract law – fraud, mistake, public policy, etc.⁷³ EU member states have also devoted attention to controlling contractual penalty clauses in adhesion and boilerplate contracts, mostly through refining rules on consumer protection.⁷⁴

However, when it comes to contractual penalty, the most important control mechanism is discretion of the courts to reduce penalty they consider exorbitant, either on their own motion or at the request of a party.⁷⁵ Less frequently, legislation prescribes the amounts or sets its cap.⁷⁶

In all of the analyzed awards tribunals applied Serbian law.⁷⁷ Serbian law contains one regulation which puts a cap on the amount of con-

⁷¹ The comparison is self imposing but not entirely correct. It is based on the fact that Art. 270(3) LCT explicitly provides that “contractual penalty may not be stipulated for pecuniary (monetary) obligations”, which is then related to the pecuniary obligations “secured by the right to claim interest”. See in that sense J. Radišić, 319 and Z. Slakoper, V. Gorenc, 253. The issue of whether a particular obligation is monetary (pecuniary) arose in arbitration practice as well. Privatization buyers regularly promise the seller (Agency for Privatization) that they will ensure, within the framework of the employees’ welfare package, regular payment of employees’ salaries for certain period of time after the conclusion of the contract. In one of the cases analyzed, breach of this obligation triggered contractual penalties (FTCA Final Award in the case no T 9/10 of 10 October 2011). Debtor claimed that the obligation in question is monetary, and that consequently the contractual penalty clause was null and void. The tribunal held that this is not so, and drew the following distinction: while an employee’s claim for salary vis à vis the employer is a monetary one, privatization buyer does not owe money to Agency, instead it owes it a different obligation – to ensure (*obligation de résultat*) to pay salaries to the employees. Agency cannot request privatization buyer to carry this obligation out by paying it (i.e. the Agency) a sum of money. Consequently, the obligation is not monetary.

⁷² See M. Konstantinović (1982), 524.

⁷³ For *argumentum a contrario* see M. Konstantinović (1982), 522. The author states that this kind of contract cannot be reviewed if it is otherwise conforming to mandatory provisions.

⁷⁴ On Council Directive 93/13/EEC on unfair contract terms see Radovan Vukadinović, “Perspektive Evropskog građanskog zakonika”, *Pravni život* 12/1996, 883. These are the so called *clauses abusives* or *unfair terms*. See D. Pavić, 394 and references cited therein. For the abuse of economic position when contracting the amount of contractual penalty, see the section discussing *clauses abusives* in consumer contracts, P. Malinvaud, 223.

⁷⁵ For the legislative history of the provision see M. Konstantinović (1982), 522 533. For comparative law see G. H. Treitel (1988), 221 233. See also P. Malinvaud, 227 228.

⁷⁶ M. Vasiljević, 651 652.

⁷⁷ For the application of the CISG as a part of domestic law see M. Đorđević, 258 et seq.

tractual penalties for delay at 5% of the contracted price for the works.⁷⁸ Given that said regulation is applied only when contracted for⁷⁹ its application is limited. However, in one of the analyzed cases they were invoked by the tribunal as an indicator that there have to be limits to the sum of the agreed penalty.⁸⁰

Serbian law provides that a court will exercise its control over the sum of the penalty due only if so requested by a party.⁸¹ Just like the courts,⁸² tribunals have interpreted the notion of ‘debtor’s request’ very broadly: any opposition to the right of the creditor to collect the penalty will, at the same time, be understood as opposition to the amount requested.⁸³ Consequently, even in absence of explicit request for reduction award will be not *plus petitio*. It is not difficult to find justification for this position: nullity of the contracts is to be observed *ex officio*, and stipulation of exorbitant sum would be contrary to public policy and *contra bonos mores*, and consequently invalid.⁸⁴ That is why the debtor need not specify the extent of reduction or the sum it considers appropriate.⁸⁵ (It is worth noting that a consistent adherence to this principle would suggest legislative approach taken by Code Civil, which empowers courts to reduce sum *ex officio*, even absent any request of a party).

The criteria for reduction are not easy to implement. LCT provides that the penalty will be reduced if it found to be *excessively high compared to the value and significance of the subject of the obligation*⁸⁶. The

⁷⁸ See Art. 43(2) of the Special usages for construction business, *Official Gazette of the Socialist Federal Republic of Yugoslavia* 18/77.

⁷⁹ See Vladimir Vodinić, *Građansko pravo, Uvod u građansko pravo i Opšti deo građanskog prava*, Pravni fakultet Univerziteta Union, Belgrade 2012, 109.

⁸⁰ Ad hoc Final Award of 1 April 2013. See also D. Hiber, 350.

⁸¹ See Art. 274 LCT. For the evolution of the possibility to reduce the amount of penalty since the principle of *pacta sunt servanda*, the reduction upon request from a party and the reduction *ex officio* see D. Hiber 354.

⁸² See the judgment of the Supreme Court of Serbia No. 591/95. See also G. Ajnšpiler Popović, 9; D. Pavić, 399 400 and case law cited therein.

⁸³ FTCA Final Award in the case no T 12/10 of 19 September 2012.

⁸⁴ Cf. art. 141(3) LCT.

⁸⁵ This has been confirmed in arbitral practice. In FTCA Final Award in the case no T 9/10 of 10 October 2011), rejecting claimant’s position that the respondent had to specify the exact sum for which the penalty should be reduced, the tribunal held that the debtor is not obliged to do so and that, if requested even in general terms, the reduction may be carried out in accordance with parameters set in the law.

⁸⁶ See Art. 524 LCT. *Disproportionateness* represents a prerequisite for introduction of reduction mechanism. Not every excessive sum will meet this threshold, only such excessive sum which is particularly disproportionate, “much higher than the damages” see G. Ajnšpiler Popović, 9. Cf. M. Konstantinović (1982), 524, who discusses the issue of contractual penalty the amount of which is excessively higher than the amount that the

quantitative criterion ('excessively high') is easier to interpret than the reference to 'value and significance of the subject of the obligation'.

LCT is not the only national statute offering somewhat vague guidelines for reduction of contractual penalty. Art 163(3) of the Swiss Code of Obligations simply provides that "At its discretion, the court may reduce penalties that it considers excessive". BGB sec 343 provides that "In judging the appropriateness, every legitimate interest of the obligee, not merely his financial interest, must be taken into account." Art. 1152 of the Code Civil empowers the court to reduce penalty even when the party has not requested reduction; 1975 amendment introduced opportunity to adjust it if it is excessively high *or* excessively low. It has been observed that the desire to regulate precisely and in detail might actually introduce uncertainty, a simple reference instead to penalty being 'excessively high' might suffice as a yardstick.⁸⁷

The wording of the yardstick has, however, changed over time in Serbian (Yugoslav) legislation. General usages on trade in goods provided that the penalty may be reduced if it is excessively high.⁸⁸ Draft code on contracts and obligations linked reduction to comparison of the penalty to "creditor's damages".⁸⁹ LCT settled for the above mentioned reference to value and significance of the subject of the obligation (General usages refer to value of the subject matter only in the context of computation of the amount of penalty due).⁹⁰ After LCT had entered into force, court practice used actual damages suffered by the creditor as the reference point.⁹¹ This is consistent with the prevailing view of predominantly compensatory nature of the contractual penalties.⁹²

creditor would have been entitled to had the court examined the value of damages caused.

⁸⁷ See M. Konstantinović (1982), 525 526. This advice, which has never been entirely applied in the Draft of the Code of Obligations and Contracts, seems to have successfully resonated more than half a century later. The Draft Civil Code of Serbia contains an alternative solution pursuant to which a reduction may be granted if it is established that the contractual penalty is excessively high. See *Civil Codes of Serbia*, Draft, book II, *Obligations*, 2009, 109.

⁸⁸ See Art. 252 of the General Usages for Trade in Goods.

⁸⁹ See Art. 219(2) of the Draft Code on Obligations and Contracts.

⁹⁰ See Arts. 253 and 254 of the General Usages for Trade in Goods.

⁹¹ See G. Ajnšpiler Popović, 9. For examples of that practice see M. Konstantinović (1982), 524 526. Cf. D. Pavić, 400 402.

⁹² D. Pavić, 395. G. H. Treitel (1988), 224 225, who remarks that legislators omit to state precisely what the agreed upon sum is to be compared to. He assumes that the comparator is the value of damage, but he opens the question of the type of damage, stating that, absent an explicit provision containing a different solution, the comparator should be the value of real damage.

Where tribunals went beyond simple restatement of the applicable legislative provisions, they have, at least indirectly, tended to refer to this compensatory function and damages suffered.

For instance, in one of the cases the debtor (privatization buyer) breached its obligation not to dispose of certain assets.⁹³ The tribunal found that, on the facts of that particular case, penalty clause was excessive (it amounted to one half of the purchase price) and reduced it to the sum equal to the value of the disposed asset (and thus indirectly to the perceived damages resulting from the breach). The tribunal observed that the penalty is of compensatory nature as the penal aspect was reflected in the provision of the Law on Privatization prohibiting restitution. When deciding on the sum of the penalties due for breach of obligation to pay salaries to the employees, the same tribunal took the total unpaid sum as the main reference point.

Another interesting case of indirect reliance on the value of damages suffered occurred in a case where, for breach of several contractual obligations, the claimant sought penalties in the exorbitant sum of over 70 million EUR.⁹⁴ Buyer was obliged to refrain from disposing of certain real estate, and the breach of that obligation was subject to contractual penalty. Buyer disposed of it, however, in order to settle its tax debt, handing the real estate over to the tax authorities, and the authorities set off its tax debt for one third of the estimated price of the real estate, in accordance with law.⁹⁵ When deciding on the reduction of the contractual penalty, the tribunal took the value of the real estate as reference point – triple the sum of the debt settled, i.e. what the real estate was actually worth.⁹⁶

Arbitration tribunals have, therefore, to a significant degree, aligned with the courts when deciding on reduction of contractual penalty. This is evident although, at times, the justifications given departed slightly from the line taken by the courts – the underlying reference (damages in light of particular circumstances of the case) remained the same.

⁹³ FTCA Final Award in the case no T 9/10 of 10 October 2011.

⁹⁴ FTCA Final Award in the case no T 12/10 of 19 September 2012.

⁹⁵ Art. 110 of the Law on Tax Procedure and Tax Administration (Official Gazette of the Republic of Serbia 80/2002 and 20/2009) provides that if a real estate, which is the object of enforcement, cannot be sold by public auction, nor by direct agreement within six months from the day of issuance of the ruling on its sale, such real estate shall be considered to have been sold to the Republic of Serbia at the value equal to one third of the determined initial value.

⁹⁶ FTCA Final Award in the case no T 12/10 of 19 September 2012. Similarly, the calculation of the maximum penalty for delay in performance (construction of an object) in the Ad hoc Final Award of 1 April 2013 revolved around the value of the obligation (i.e. object to be construed) which was late (i.e. not yet performed as of the time of the dispute).

4. CONCLUDING REMARKS

National legislators take different approaches to whether and in what manner the parties may agree on sums payable in the event of breach of obligations. Being a Civil Law country, Serbia allows for contracting for contractual penalties. They potentially serve not only compensatory, but penal goals as well. Despite their frequent use and fairly rich court practice and doctrine, they consistently present problems in practical application, and did so particularly acutely in several arbitral decisions which dealt with privatization agreements. Arbitral practice is normally not reported, thus depriving local legal community from valuable insight into specific issues and approaches that have arisen away from the eyes of the public.

Privatization context involved not only problem of characterization of the secured obligations, but also the potential issues of combining contractual penalties with bank guarantees and with the prohibition of restitution contained in the Law on Privatization. In all those circumstances, although it was necessary for them to adhere to the established practice of the Serbian and ex-Yugoslav courts, the tribunals took the well-established path, although they had to apply it in a context not normally encountered in the court decisions.

Even outside of the privatization context, tribunals were confronted with controversial issues, such as e.g. the issue of whether a contractual penalty for delay may be collected even before the secured obligation is eventually enforced. To this day there has been no comparable court case reported on the matter.

Finally, on issue of reduction of the contractual penalties the tribunals applied seemingly the same methodology of the courts. In doing so, they did not treat contractual penalties as a substitute for the regular process and methodology of compensating damages. Nevertheless, every case in which reduction took place demonstrated tribunals' effort to decide on reduction only after it has anchored itself around some reference number which could potentially be relevant in the context of the calculation of damages. As always when it comes to discretion and numbers, 'proportionality' and 'appropriateness' are standards which are in the eye of a beholder.