

Liquidated Damages and Penalties in International Construction Agreements



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Contractual Options: Liquidated Damages and Penalties

Swiss law is generally perceived as a well-balanced, predictable and flexible framework for international commercial contracts. In the construction context, the focus of the legal provisions is on various potential breaches of contract by the contractor, with the right to damages being a key remedy for the employer within a nuanced range of further options.

The parties to a commercial contract governed by Swiss law are at liberty to tailor the remedies for breach to their specific needs. In construction contracts, employers and contractors frequently choose to supplement the statutory provisions on damages with liquidated damages clauses or contractual penalties. The two options have in common that they provide for a fixed or easily determinable sanction (in most cases a sum of money) that may be claimed by a party if the other party is in breach of specific obligations.

Both options are appealing in the plant construction context, where it can be particularly difficult to prove losses caused by delays, missed performance parameters or defects in the works delivered. An upfront agreement on a lump sum payment not only makes enforcement easier for the employer, but also allows contractors to predict their financial exposure in the event of a breach. By providing for a fixed amount, such clauses reduce the potential for lengthy and costly legal proceedings.

To achieve these advantages, it is important that the parties opt for the instrument that corresponds best to their needs and structure it properly. The choice between liquidated damages and contractual

penalties will have an impact on a number of issues, including whether proof of a damage suffered is required in order for the lump sum to be due, whether specific performance can be claimed in addition to the payment due, and whether and in what circumstances the agreed amount can be reduced by a court or arbitral tribunal.

The main difference between the two indemnification options is their intended purpose: Contractual penalties primarily aim to put pressure on the promising party and to incentivize it to perform the contract properly and in due time. This forward-looking purpose goes hand in hand with a punitive element and a compensatory function in the event of an actual breach. Liquidated damages are (as their name implies) pre-agreed damages. As such, they have a purely compensatory function. By determining the amount of damages that may be claimed by a party in the event of a breach, liquidated damages clauses simplify the enforcement of the injured party's damages claim.

The interpretation of contractual provisions under Swiss law depends on the true intention of the parties, rather than the wording they choose (Article 18 CO). To avoid any uncertainty in this respect, it is therefore advisable for the contracting parties to be clear on the purpose that they attribute to a given indemnification clause, as this will affect the legal consequences flowing from such clause.

Advantages and Disadvantages of Each Option

Necessity of a Loss

It follows from the purpose and contractual basis of a penalty clause that the penalty is due whenever the agreed con-

ditions (i.e. a specific breach of contract imputable to the penalty debtor) are met, irrespective of whether the creditor has actually suffered any loss (see Article 161(1) CO).

By contrast, a claim for liquidated damages as a form of damages requires the existence of an actual loss, even if such loss does not need to be quantified. Whether the burden of proof in this context is on the creditor or the debtor is a different question and subject to debate. As the Swiss Federal Supreme Court has not yet ruled on the matter, it is advisable to provide for express language in the contract as to whether the claim for liquidated damages requires proof (or at least prima facie evidence) of the existence of a loss or, conversely, whether the agreed amount is due without such proof, but the party in breach can avoid liability by proving the absence of any actual loss.

Compensation of a Loss in Excess of the Agreed Payment

Penalties can be combined with damages if and insofar as the actual loss exceeds the amount of the penalty, but only if the aggrieved party can prove the other party's fault (Article 161(2) CO). The parties can however agree that additional damages are due unless the party in breach proves that it is not at fault.

Liquidated damages are in principle only owed in the agreed amount. However, a party that breached the contract with unlawful intent or gross negligence may not rely on the liquidated damages clause and the concomitant liability cap. Therefore, it owes the aggrieved party additional damages for any loss exceeding the agreed amount (see Article 100(1) CO). Moreover, parties are free to agree on relative liquidated damages that allow the injured party to claim additional compensation if the loss suffered exceeds the agreed liquidated damages. The injured party then bears the burden

of proving any exceeding loss.

Reduction of Excessive Lump Sums

Swiss law is based on the principle that a contractual penalty can be fixed at any amount (Article 163(1) CO). As an exception to this rule, the competent court or arbitral tribunal is required to reduce the amount agreed if and insofar as it turns out to be excessively high (Article 163(3) CO). Whether and to what extent a penalty must be reduced is a matter of discretion. As a reduction of a penalty amount interferes with the parties' contract, the Supreme Court has emphasized that it may only be granted with restraint. In practice, courts and arbitral tribunals tend to reduce a penalty only to the extent that it manifestly exceeds the creditor's interest in the performance of the secured obligation. While the penalty debtor bears the burden of proof for the facts and circumstances justifying a reduction, the creditor is expected to cooperate by providing at least some substantive indications as to the loss suffered.

Liquidated damages can be agreed to be relative in the sense that the injured party must only be indemnified for its actual loss, which may be less than the amount agreed. The burden of proof for such lower loss lies with the party in breach. In the absence of such an agreement, liquidated damages must generally be paid in full. It is, however, widely acknowledged that Article 163(3) CO applies mutatis mutandis to liquidated damages which noticeably exceed the loss actually suffered by the injured party. As with penalties, the possibility to reduce the amount agreed must be used with restraint.

Relationship with the Right to Specific Performance

Unless agreed otherwise, a party may not combine a contractual penalty for non-performance and non-conforming

performance with the right to specific performance (Article 160(1) CO). An agreement that performance is owed in addition to the penalty can be express or implied and must be proven by the injured party. In particular, if the penalty is disproportionately lower than the performance interest, this might imply that the parties intended for the right to performance and the penalty to be cumulative (possibly only up to the amount of the performance interest).

Contractual penalties for a failure to comply with the agreed time or place of performance can be claimed in addition to performance unless the injured party has expressly waived the right to the penalty or accepted performance without reservation (Article 160(2) CO). In any event, the right to specific performance lapses if the defaulting party shows that the contract was meant to allow a withdrawal from the contract against payment of the penalty (Article 160(3) CO).

Liquidated damages for delay or non-conforming delivery can be claimed in addition to specific performance or to the remedies for non-conforming works provided by Swiss statutory law (Article 368 CO). By contrast, liquidated damages for non-performance exclude any claim for specific performance.