Liquidated damages or contractual penalty

Under Swiss law

Swiss law plays an important role in international contracts in general and in contracts for construction projects in particular. Swiss law is frequently chosen to govern such contracts because it is considered to be balanced with respect to the contractual parties as well as to the project and, accordingly, does not favor one or the other party.

The purpose of this article is to provide an overview of the differences between liquidated damages and a contractual penalty which are both allowed and commonly used under Swiss law, in particular in construction agreements.

Common law vs. civil law approach

Whilst there are many legal issues that are dealt with in the same or in a similar way by the civil law and common law systems, there remain also substantial differences. The approach regarding a contract clause penalizing one party for non-performance or breach of contract represents an example of such a difference. Whilst under both legal systems the parties to a contract may simplify the mechanism to claim for damages by including an express clause setting out exactly how much a party can claim for specific breaches (liquidated damages), the approach regarding contractual penalties (penalty to be paid in case of non-performance or breach of contract with the intent to encourage performance) is quite different.

Most common law jurisdictions do not allow for liquidated damages which represent a penalty. Accordingly, a liquidated damages clause is generally only enforceable where the court finds that the actual damage is difficult to estimate, but where the amount of liquidated damages represents a reasonable compensation and is not disproportionate to such actual or anticipated damage. If the liquidated damages are disproportionate, however, they may be declared a penalty with the result that such a clause is void and recovery will be limited to the actual damage resulting from the breach.

Already the Napoleonic Code, upon which most civil codes are based, allowed for penalties to encourage performance of contractual obligations. Today, even though the scope is generally narrowed by the possibility of a judicial reduction in case of excessiveness, contractual penalty clauses are still allowed in most civil law jurisdiction.

Under Swiss law, there is a distinction between liquidated damages (Schadenspauschale) and contractual penalties (Konventionalstrafe), even though statutory law only explicitly regulates the contractual penalty.

Liquidated damages and contractual penalty under Swiss law

Relevant legal principles of interpretation

Freedom of contract and priority to the parties’ intentions

Under Swiss law, freedom of contract is an important principle which has its roots in the Swiss Constitution. Swiss statutory law contains many general and specific contractual rules and also regulates certain types of contracts such as purchase and work contracts. However, subject to mandatory legal provisions, the parties are generally free to deviate from the statutory law by altering provisions or adding new ones.
In view of the high value given to the principle of freedom of contract, a Swiss judge will be reluctant to interpret the contract differently from the parties’ demonstrated intentions.

**Interpretation of the contract**

As a result of the principle of freedom of contract, contracts will be interpreted in accordance with the proven intention of the parties which may deviate from the literal wording of a contract.\(^1\) For example, if the parties agree in a written contract on the purchase of “whale meat”, while writing “shark meat”, a Swiss judge will oblige the seller to deliver “whale meat” provided that one party proves that this was the parties’ real intent at the time of the conclusion of the contract.\(^2\)

The goal of the interpretation of a term or a rule in a contract is to identify the actual and mutual intention of the contracting parties. If this actual and mutual intention cannot be established, the court must decide on the assumed mutual intention of the parties by applying the so called “Vertrauensprinzip”.\(^3\) In English this principle may be translated as “bona fide” or “good faith principle”.

On a first level, the judge will have to discover the actual and mutual intention of the contracting parties. If such actual and mutual intention cannot be identified and if the validity of the contract is not in dispute, on a second level, a Swiss judge will amend the contract in accordance with the hypothetical intention of parties acting in good faith.

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**Liquidated damages (Schadenspauschale)**

**Purpose and prerequisites**

Liquidated damages (Schadenspauschale) are not explicitly regulated by statutory Swiss law but nevertheless admissible. The purpose of liquidated damages is not to penalize\(^4\) but rather to compensate for an anticipated damage. Under Swiss law – in contrast to contractual penalties – liquidated damages require as a prerequisite that any damages were incurred.\(^5\) However, since there is no need to prove the quantum of the damage, liquidated damages represent an easing of the creditor’s burden of proof.

With regards to the debtor, liquidated damages provide for more transparency regarding the financial consequences of a breach of contract, since liquidated damages clauses usually contain a limitation of liability.

**Limitations**

If liquidated damages by far exceed the actual damage incurred, such liquidated damages are also subject to the judicial review and possible reduction applying to the contractual penalty (art. 163 para. 3 Swiss Code of Obligations (“CO”) by analogy; see below).\(^6\)

Since liquidated damages generally represent a contractual limitation of liability on the respective amount of the liquidated damages, it is generally not possible for the creditor to claim for additional damages, except in cases of unlawful intent or gross negligence by the debtor (under Swiss law, an agreement to waive liability for gross negligence or unlawful intent is null and void if concluded in advance).\(^7\)\(^8\)

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1. Article 18 Swiss Code of Obligations (“CO”).
5. Gauch, marginal note 3851.
7. Art. 100 para. 1 CO.
8. Gauch, marginal note 3851.
Contractual penalty (Konventionalstrafe)

Purpose and prerequisites

According to Swiss law, the parties may agree upon a contractual penalty (Konventionalstrafe) that is triggered in case the debtor is in breach of a specific contractual obligation (“Main Obligation”), e.g. in case of non-performance, delay, etc. In spite of its name, the purpose of a contractual penalty is primarily to encourage performance of the Main Obligation and, therefore, to secure the interests of the creditor rather than solely a punishment of the debtor.9 Further, like the concept of liquidated damages, a contractual penalty is often used where the calculation of damage is difficult or impossible, e.g. in connection with non-compete clauses in employment contracts, confidentiality agreements or for delays in construction agreements.

The statutory provisions governing the contractual penalty are contained in articles 160 – 163 CO.

Essentially (with the exceptions of art. 163 para. 2 half-sentence 1 and art. 163 para. 3 CO), these statutory provisions are non-mandatory. Accordingly, the substance of a contractual penalty and, in particular, the relation between the claim for specific performance and the contractual penalty is to be determined according to the true intention of the parties. Where the parties did not agree upon or where it is impossible to determine their true intention, the presumptions of art. 160 para. 1 and 2 CO as well as of art. 161 para. 1 and 2 CO apply.

In order to agree upon a contractual penalty, the general principles regarding conclusion of contracts apply. In particular, a contractual penalty is void if the purpose of the clause is to reinforce an unlawful or immoral Main Obligation (art. 163 para. 2 CO).

As a rule, payment of an amount of money will be agreed as contractual penalty. The amount of the contractual penalty forms part of the essentialia negotii whilst it is sufficient that the amount is determinable.10

Nevertheless, in a recent decision the Swiss Federal Tribunal (“SFT”) left the position it had taken in a 1954 precedent11 that a contractual penalty can only consist in a promise to deliver an actual performance. The SFT ruled that the forfeiture of a right could also be construed as a contractual penalty.12

What conditions (non-performance or breach of the Main Obligation such as delay, violation of a duty of omission, etc.) trigger the contractual penalty is also determined by the agreement between the parties (possibly under consideration of the hypothetical intention of parties acting in good faith; see above). Generally, any Main Obligation may be reinforced with a contractual penalty except for cases where the law provides for a final and mandatory legal consequence for the respective breach of obligation.13

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9 SFT, decision of 23 April 2009, 135 III 433, cons. 3.1.
11 SFT, decision of 6 July 1954, BGE 80 II 123, cons. 3a and 3b.
12 SFT, decision of 23 April 2009, 133 III 433, cons. 3.
13 Gauch, marginal note 3788.
Debtor’s obligation to pay the contractual penalty

Principle

If the agreed conditions (non-performance or breach of the Main Obligation) are fulfilled, the contractual penalty becomes immediately due. In particular - in the absence of an agreement to the contrary - the creditor is not required to prove any actual damage incurred for the enforcement of the contractual penalty (art. 161 para. 1 CO).

If the creditor has incurred damage and that damage amounts to more than the amount of the contractual penalty, the excess amount may be claimed in addition to the contractual penalty, provided that the creditor can prove that the damage occurred due to a fault of the debtor.

Exceptions/reduction

Under Swiss law, contractual penalties may generally be agreed upon in any amount. However, upon request by the creditor, grossly excessive contractual penalties may be reduced to an adequate amount at the discretion of the judge (art. 163 para. 3 CO). This judicial reduction represents a mandatory provision and even a rule of public policy.

The term “excessive” is not defined by Swiss statutory law. Whether a contractual penalty is excessive depends on the circumstances of the individual case at the time of the non-performance/breach of the Main Obligation. Inter alia, the following criteria are taken into consideration:

- Main criterion: the interest of the creditor in performance of the Main Obligation; the contractual penalty is excessive if there is an obvious disproportion between the amount agreed and the creditor’s interest in performance of the Main Obligation.
- Secondary criteria: type and duration of the contract; seriousness of the breach; security of the fault of the parties; the economic situation of the parties; etc.

The debtor bears the burden of proof for the facts and the excessiveness.

Relation of the penalty to the claim for specific performance

Legal presumption of alternativity

In the absence of an agreement to the contrary, the creditor may either request performance of the Main Obligation or the contractual penalty. If the contractual penalty is chosen, the creditor forfeits its right to demand for specific performance.

Accumulation

A cumulative contractual penalty may be agreed upon by the parties and is statutorily presumed in case the penalty was stipulated for the compliance with deadlines or with the place of performance (see art. 160 para. 2 CO). In case of a cumulative penalty the creditor can request performance of the Main Obligation and payment of the contractual penalty.

Exclusivity

In case the parties agreed an exclusive contractual penalty, the penalty corresponds to the minimum amount, but also to the maximum amount that the creditor can demand. It is presumed that the creditor cannot claim for additional damages (limitation of liability; see above).

This restriction allows the obligor to withdraw from the contract by paying the amount of the penalty (art. 160 para. 3 CO).

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14 Gauch, marginal note 3797.
15 SFT, decision of 15 March 2007, 133 III 201, cons. 5.2.
16 Bak-Ehrat, marginal note 15 to art. 163 CO.
17 SFT, decision of 15 March 2007, 133 III 201, cons. 5.2.
20 SFT, decision of 17 July 1979, 105 II 200, cons. 6.
21 SFT, decision of 30 October 2006, 1033 III 43, cons. 3.3.2.
Distinction between liquidated damages (Schadenspauschale) and contractual penalty (Konventionalstrafe)

Liquidated damages have no punitive function, but are directed at anticipated compensation for damage. Generally, the creditor has to prove the existence of actual damage but not its extent.

In contrast, if the parties agree upon a contractual penalty, generally the creditor is not required to prove any actual damage incurred for the enforcement of such a contractual penalty.

To assess whether the parties agreed upon liquidated damages or a contractual penalty, the true intention of the parties is relevant rather than the potentially incorrect designation. On the one hand, the circumstance that the parties intended to primarily provide for a form of leverage, speaks for the contractual penalty. On the other hand, providing for economical compensation rather suggests liquidated damages.

22 SFT, decision of 28 October 1969, 95 II 532, cons. 5.