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Punitive and Compensatory Contract Damages: A Comparative Study of UCC, Chinese, and International Law

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PUNITIVE AND COMPENSATORY CONTRACT DAMAGES: A COMPARATIVE STUDY OF UCC, CHINESE, AND INTERNATIONAL LAW

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I. TWO SYSTEMS

A. Compensatory Damages Under the UCC and China Foreign Economic Contract Law (CFECL)

The general rule laid down by the Uniform Commercial Code for damages resulting from a breach of contract is that penal damages may not be recovered "except as specifically provided in this Act or by other rule of law."[1] According to this general rule, "[t]he basic purpose of contract damages has been to compensate the aggrieved party, not to punish the breaching party."[2]

In the context of contract law, Anglo-American law generally follows a policy of restricting recovery to compensatory damages instead of punitive damages. Professor Alan Farnsworth suggests that "[o]ur system . . . is not directed at *compulsion* of *promisors* to *prevent* breach; rather it is aimed at *relief* to *promisees* to *redress* breach."[3]

Damages allowed by the China Foreign Economic Contract Law (CFECL)[4] are also compensatory rather than punitive. Under

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1. U.C.C. § 1-106(1) (1990).

2. TĂNG THÀNH TRAI LÊ & EDWARD J. MURPHY, SALES AND CREDIT TRANSACTIONS HANDBOOK § 5.39, at 298 (1985).

3. E. Allan Farnsworth, *Legal Remedies for Breach of Contract*, 70 COLUM. L. REV. 1146, 1147 (1970).

4. China Foreign Economic Contract Law (CFECL) is the statute specially applied to contract relationships between a Chinese enterprise or another type of Chinese economic organization, and a foreign enterprise, person, or another type of foreign

CFECL, "damages by a party for breach of contract should be equal to the loss suffered by the other party as a consequence of the breach."[5] Today in China, both in foreign economic litigation and in the arbitration of the China International Economic and Trade Arbitration Commission (CIETAC), claims for punitive damages are seldom upheld unless the law applied to the contract is that of a foreign country where punitive damages are allowed. In fact, few cases can be found in which claims for punitive damages were supported for breach of contracts between Chinese and foreign parties.

B. Punitive Damages Under the German Civil Code and China Economic Contract Law

In Germany a party in breach may be punished. According to German Civil Code (GCC), where parties agree that the breaching party has a duty to pay damages for nonperformance of an obligation or failure to perform in a proper manner, damages may be awarded even though enforcing the agreement will result in punishment.[6]

China Economic Contract Law (CECL),[7] which governs Chinese native economic transactions, also bears a pronounced penal color.[8] CECL employs a system of "double-returned-earnest money."[9] If a party paying earnest money fails to fulfill the terms of the contract, that party loses the right to have the earnest money returned; however, if the party receiving the earnest money fails to perform,

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economic organization.

5. CHINA FOREIGN ECONOMIC CONTRACT LAW [CFECL] art. 19 (1993) (P.R.C.), *translated in* CHINA LAWS FOR FOREIGN BUSINESS, 1 BUSINESS REGULATIONS 6627 (1993).

6. BÜRGERLICHES GESETZBUCH [BGB] art. 339 (F.R.G.), *translated in* THE GERMAN CIVIL CODE 56 (Simon L. Goren trans., rev. ed. 1994).

7. China Economic Contract Law (CECL), implemented in 1981 and amended in 1993, governs the economic contracts between two Chinese parties. CECL, along with various regulations for the implementation of CECL and the judicial explanations of CECL by the Chinese Supreme People's Court, jointly constitute a system resolving economic contract disputes between Chinese contracting parties.

8. Learning about this statute is of significance to a foreign investor since enterprises with foreign capital set up in China are characterized as Chinese enterprises under Chinese law. Therefore CECL governs the contractual disputes between this kind of enterprise and other Chinese enterprises.

9. In China earnest money usually means the sum paid by one party who, under a contract, has a duty to pay prior to the other party's performance. Sometimes no distinct difference exists between earnest money and advance payment.

that party must pay twice the amount to the other party.[10] For a sale contract, the paying party is usually the buyer and the sum paid is often equivalent to one third of the total value of the contract. A buyer who repudiates the contract cannot get the sum returned in an action.

Other types of punitive damages include liquidated and legal damages for breach. CECL provides that

> if one of the parties concerned is in breach of an economic contract, it shall pay breach fees to the other party. In a case where breach of contract causes the other party to incur losses which exceed the breach fees, the party in breach of the contract shall pay additional compensation to make up the balance.[11]

Under the Opinions on Several Questions for the Implementation of CECL (Opinions) delivered by the Supreme People's Court of the People's Republic of China,[12]

> breaching damages are the sum which shall be paid by the party who fails to perform an economic contract or fails to completely perform the contract in fault to the other party according to contract or law, no matter whether the breach has led to the loss suffered by the other party or not.[13]

This explanation demonstrates that CECL damages for breach are punitive in nature to the breaching party. Under the Opinions,

> [b]reaching damages include legal breaching damages and liquidated breaching damages. The former is clearly provided by statutes—for example, Regulations on Contracts for the Purchase and Sale of Industrial and Mineral Products (RCPSIMP) and Regulations on Contracts for the Purchase and Sale of Agricultural By-products (RCPSABP).[14] The

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10. CHINA ECONOMIC CONTRACT LAW [CECL] art. 14 (amended 1993) (P.R.C.), *translated in* CHINA LAWS FOR FOREIGN BUSINESS, 1 BUSINESS REGULATION 6405, 6407 (1993).

11. *Id.* art. 31, *translated in* CHINA LAWS FOR FOREIGN BUSINESS, 1 BUSINESS REGULATION 6423.

12. The Opinions on Several Questions for the Implementation of CECL [hereinafter Opinions] were delivered in 1984 and have been followed by people's courts at different levels and in different areas in China.

13. *Id.* at 2(2)(1).

14. The State Council of the People's Republic of China formulated the RCPSIMP and RCPSABP in 1984 for implementation of CECL. *See* JEROME A. COHEN, CONTRACT LAWS OF THE PEOPLE'S REPUBLIC OF CHINA 69 (1988).

> latter is agreed by contractual parties when contracts are made. If there is no provision stipulating breaching damages in contracts, breaching damages can be ascertained under the concerned regulations in force at the time when contracts are signed.[15]

A variety of regulations, and detailed rules concerning different sorts of contracts, provide for the amount of breaching damages or the method of ascertaining breaching damages.[16] For instance, the RCPSIMP guarantees that the seller must pay the buyer damages for breach of contract if the seller fails to deliver the goods.[17] The specific ratio between the breaching damages and the total value of the contract may be agreed by the seller and buyer when they sign the contract.[18]

However, where no provision in the contract controls liquidated damages, and the seller fails to deliver goods, the RCPSIMP provides the following guidelines:

> Breach of contract damages for general-purpose products shall be 1 to 5 percent of the total value of the goods that the supplier fails to deliver; breach of contract damages for special-purpose products shall be 10 to 30 percent of the total value of the portion of the goods that the supplier fails to deliver.[19]

II. PROBLEMS ARISING FROM LIQUIDATED DAMAGES FOR BREACH OF CONTRACT

Liquidated damages for breach of contract creates two distinct problems: maintaining reasonable limits on remedies and avoiding undue punishment. The first problem occurs in countries recognizing only compensatory damages for breach of contract, and the second must be resolved by countries allowing punitive damages. China, which has adopted both compensatory and punitive damages, cannot avoid either problem.

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15. Opinions, *supra* note 12, at 2(2)(2).

16. For example, Regulations on Contracts for Construction; Regulations on Contracts for Property Insurance; Detailed Rules for Storage Contracts; Detailed Rules for Railway Transportation of Goods; and Detailed Rules for Highway Transportation of Goods.

17. REGULATIONS ON CONTRACTS FOR THE PURCHASE AND SALE OF INDUSTRIAL AND MINERAL PRODUCTS, art. 35(1) (1984), *translated in* COHEN, *supra* note 14, at 79.

18. *Id.*

19. *Id.*

A. *How to Make Reasonable Remedies for Liquidated Breaching Damages*

1. The answer from the UCC

The UCC maintains reasonable limits on remedies by requiring that

> [d]amages for breach by either party may be liquidated in the agreement but only at an amount which is reasonable in light of the anticipated or actual harm caused by the breach, the difficulties of proof of loss, and the inconvenience or nonfeasibility of otherwise obtaining an adequate remedy. A term fixing unreasonably large liquidated damages is void as a penalty.[20]

Generally, where damages are difficult to ascertain based on the circumstances of the case, liquidated damages will be regarded as reasonable unless the amount of the damages is excessively large. The California case *Blank v. Borden*[21] illustrates this rule. A real estate broker entered into a contract with a landlord to sell the landlord's weekend home.[22] The contract granted the broker the exclusive and irrevocable right to sell the property for seven months from the date of the agreement.[23] It further provided that the agent would receive six percent of the selling price if the property was sold during this period.[24] If the owner withdrew the property from sale without the agent's consent, the agent would receive six percent of the price for the property stated in the agreement.[25] Two months later, while the broker diligently attempted to obtain a purchaser, the landlord, without justification, orally notified the broker that the property was no longer for sale.[26]

The California Supreme Court concluded that the withdrawal-from-sale clause in an exclusive right-to-sell contract does not constitute a void penalty provision.[27] The broker is only entitled

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20. U.C.C. § 2-718(1) (1990).
21. 11 Cal. 3d 963, 524 P.2d 127, 115 Cal. Rptr. 31 (1974).
22. *Id.* at 966, 524 P.2d at 128, 115 Cal. Rptr. at 32.
23. *Id.*
24. *Id.*
25. *Id.*
26. *Id.* at 967, 524 P.2d at 129, 115 Cal. Rptr. at 33.
27. *Id.* at 970, 524 P.2d at 130, 115 Cal. Rptr. at 34.

to compensation upon sale of the property.[28] The court reasoned that when a sale is effected, the compensation received is a percentage of the sale price regardless of the amount of effort expended by the broker.[29] Therefore, the "damage" sustained by the broker did not depend on the amount of effort made prior to the breach but rather on the value of the lost opportunity to make a sale and thereby receive compensation.[30] "The determination of this value would clearly degenerate into an examination of fictional probabilities—e.g., whether the broker, if allowed to continue . . . efforts for the full term of the contract, would have [successfully located] a buyer and effect[ed] a sale."[31]

A distinct problem arises when the method for anticipating harm caused by breach of contract is reasonable but liquidated damages significantly exceed the actual harm. For example, a contract between a Chinese and a U.S. corporation for the sale of one cargo of metallurgical coke provided that ash in the goods should be under 11.5%. However, if the percentage was between 11.5 and 12%, the Chinese seller would pay the buyer $1.00 per metric ton (mt) for every 1% of the increase of ash, and, if the percentage was between 12 and 13%, the seller would pay $3.00/mt for every 1% of the increase. The contract further stipulated that the buyer could reject goods when the ash was above 13%. Other specifications controlled moisture content, size, sulfur content, and volatile matter content, with corresponding price reductions for nonconformity. Another term in the contract provided that U.S. law would govern disputes between the contractual parties. Upon delivery, the buyer found that the ash was over 15% and that there were some other inconformities with the specifications. Rather than reject the coke, the buyer chose to reduce the price, which, under the contract, amounted to a substantial part of the total value of the contract. However, the buyer failed to notify the seller of the actual harm sustained.[32] Suppose that the reduction of the price under the contract reflected exactly the reduced quality

28. *Id.* at 972, 524 P.2d at 132, 115 Cal. Rptr. at 36.

29. *Id.*

30. *Id.* at 972-73, 524 P.2d at 132, 115 Cal. Rptr. at 36.

31. *Id.* at 973, 524 P.2d at 132, 115 Cal. Rptr. at 36. Similar examples can be found in the case of breach of a covenant not to compete, where the losses resulting from such a breach "were wholly uncertain and incapable of estimation otherwise than by mere conjecture." Williams v. Dakin & Bacon, 22 Wend. 200, 208 (N.Y. 1839).

32. This dispute remains unresolved. Concerns about expensive attorney's fees may account for the Chinese seller's reluctance to sue the buyer in an American court.

of the goods and was therefore reasonable. If the buyer resold the cargo at the original price, in a rising market, the buyer would suffer no loss due to the deficient quality. The question becomes whether the contract terms fixing the damages are void.

Some U.S. courts hold that "if damages could be easily ascertained, liquidated damages would be of little use since any departure from the actual harm would be looked upon as unreasonable."[33] Taken literally, however, under UCC section 2-718(1), liquidated damages in a contract are enforceable if they are reasonable in light of anticipated harm. Hence, in the coke hypothetical, a reasonable relationship between the price reduction and the quality validates the schedule of damages in the contract.

Both of the above views may be too extreme. Generally, the amount of liquidated damages must be reasonable. However, determining whether liquidated damages are reasonable in light of anticipated or actual harm does not ensure that they are reasonable in light of the totality of the circumstances. Many U.S. courts feel that even if the estimate is deemed to be reasonable, the evidence of actual damage may still be relevant. In *Equitable Lumber Corp. v. IPA Land Development Corp.*[34] the New York Court of Appeals held that the UCC test was disjunctive—valid if reasonable in light of either anticipated or actual harm.[35] But even if the test is met, the clause may still be invalid under the last sentence of the subsection—"[a] term fixing unreasonably large liquidated damages is void as a penalty"[36]—if "it is so unreasonably large that it serves as a penalty rather than a good faith attempt to pre-estimate damages."[37] Another court said that the absence of harm may result in closer judicial scrutiny of the contractual penalty.[38]

2. Limitations on liquidated damages under CFECL

CFECL includes a liquidated damages provision for contracts between Chinese economic enterprises and foreigners:

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33. Interstate Indus. Uniform Rental Serv., Inc. v. Couri Pontiac, Inc., 335 A.2d 913, 921 (Me. 1976); *see also* Hubbard Business Plaza v. Lincoln Liberty Life Ins. Co., 649 F. Supp. 1310, 1316 (D. Nev. 1986) (holding that in Nevada, liquidated damages must not be disproportional to the actual damages).

34. 344 N.E.2d 391 (1976).

35. *Id.* at 395.

36. U.C.C. § 2-718(1).

37. *Equitable Lumber*, 344 N.E.2d at 395.

38. Norwalk Door Closer Co. v. Eagle Lock & Screw Co., 220 A.2d 263 (Conn. 1966).

> [Contracting] parties may agree upon . . . a certain amount of liquidated damages . . . if one party breaches the contract; and may also agree upon a method for calculating the damages arising [as a possible consequence of the] breach of contract.
>
> The above-mentioned liquidated damages shall be regarded as compensation for the loss caused by breach of contract. However, if the liquidated damages agreed upon in the contract [are] much more or less than the loss, the parties may request an arbitration body or court to [reduce] or increase [them] appropriately.[39]

Under this provision, the court may adjust liquidated damages in light of the specific circumstances of a particular case. However, the stated policy of CFECL, limiting damages to compensation rather than punishment, prevents a punitive result. Chinese law does not articulate factors to be considered by courts when adjusting liquidated damages, so UCC section 2-718(1) may be used for reference.

B. How to Avoid Undue Punishment Caused by Liquidated Breaching Damages

1. The rules under the German Civil Code

Even civil law countries recognizing punitive damages place certain limitations on agreed damages. Under the GCC, if the amount of punitive liquidated damages is excessively large and the debtor requests a reduction, a court may reduce the damages to an appropriate amount.[40] However, the court's power to reduce damages is limited. A court may only assert such power upon request by the parties who are so-called debtors—parties who have breached contracts and then face the cost of liquidated damages. In addition, when ascertaining the amount of damages, the court must consider all the normal interests that creditors are entitled to in addition to the interests in property.[41] In deciding whether the amount of liquidated damages is excessive, the court will look beyond the economic loss and consider other losses, including any loss in reputation. This rule

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39. CFECL art. 20, *translated in* CHINA LAWS FOR FOREIGN BUSINESS, 1 BUSINESS REGULATION 6627 (1993).

40. BGB art. 343(1), *translated in* THE GERMAN CIVIL CODE 56-57 (Simon L. Goren trans., rev. ed. 1994).

41. *Id.* art. 343(1).

may lead to much larger damages than those ascertained under the UCC.

2. The rules delivered by the Chinese Supreme People's Court

No special provision in CECL addresses liquidated damages for breach. However, the Chinese Supreme People's Court Opinions[42] offer rules on the nature of liquidated damages, and on the devices to avoid excessive punishment.

Under the Opinions the breaching party must pay liquidated damages regardless of whether the breach caused any loss.[43] In the same section the Opinions stated that: "Where a contract stipulates damages . . . no more damages other than that stipulated shall be paid if the economic loss can be recovered by payment of the stipulated damages."[44] According to this definition, liquidated damages are compensatory when the value of actual harm exceeds the amount of liquidated damages, and under such circumstances the aggrieved party is not entitled to damages beyond actual harm. However, when the value of the actual harm falls below the amount of liquidated damages, the difference paid by the breaching party becomes punitive in nature. Liquidated damages become entirely punitive in their nature when a breach of contract has caused no loss.

To avoid excessive punishment caused by liquidated damages, the Opinions offer the following provision:

> The amount of damages can be agreed [to] by both parties, but the amount cannot be reduced where a contract is breached intentionally. For negligent breach of contract, damages may be reduced to an appropriate amount but only if the breaching party [has] financial difficulties and requests the reduction, or the breach has caused no economic harm to the other party.[45]

This provision demonstrates that liquidated damages are generally enforced unless a party negligently—rather than intentionally—breaches the contract, and requests a reduction in damages either claiming financial hardship, or demonstrates that the breach has caused no harm to the other party.

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42. *See supra* note 12.
43. *See supra* note 13 and accompanying text.
44. Opinions, *supra* note 12, at 2(2)(1).
45. *Id.* at 2(2)(3).

III. COMMENTARY ON THE TWO SYSTEMS

A. *The International Tendency*

The United Nations Convention on Contracts for the International Sale of Goods (CISG), effective in 1988, and adopted by both the United States and the People's Republic of China, provides that "[d]amages for breach of contract by one party consists of a sum equal to the loss, including loss of profit, suffered by the other party as a consequence of the breach."[46]

This provision confirms that damages for breach of contract can only be compensatory, not punitive. It also demonstrates that most countries recognize the principle limiting damages for breach of contract to compensation rather than punishment, at least in the context of international transactions.[47]

B. *The Necessity for Deterring Breach of Contract by Punishment?*

Advocates of punitive damages maintain that punishing the breaching party offers the most effective way to prevent breach of contract. However, the judicial practice of those countries demonstrates that compensatory damages alone may achieve this goal. As long as a decision or arbitration award can be enforced, the breaching party cannot benefit from a breach of contract if faced with compensatory damages. If a seller refuses to deliver goods at a price stipulated by contract in order to avoid sustaining a loss due to a rise in the market price, the buyer under a compensatory damages scheme has two options. The buyer may buy replacement goods and recover the difference between the contract price and the price in the substitute transaction,[48] or the buyer may recover the difference between the price fixed by contract and the market price without purchase.[49] Generally, recovery under either option is the same since the buyer will normally buy the replacement goods at market price.

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46. United Nations Convention on Contracts for the International Sale of Goods, Apr. 11, 1980, art. 74, 19 I.L.M. 668, 688 (hereinafter CISG].

47. By May 1994, apart from the Anglo-American countries which generally recognize only compensatory damages for breach of contract, many civil law countries have accepted the Convention, including Argentina, Austria, Chile, Denmark, Egypt, Finland, France, Germany, Italy, Mexico, the Netherlands, Norway, Spain, Sweden, and Switzerland.

48. U.C.C. § 2-712 (1990); CISG, *supra* note 46, art. 75.

49. U.C.C. § 2-713; CISG, *supra* note 46, art. 76.

Under each formula the loss that the seller attempts to avoid by refusing delivery of goods equals the damages the seller has to pay because of the breach. Furthermore, in such a case, the seller in breach ordinarily has to pay costs incurred during a lawsuit or arbitration. In many cases such litigation costs exceed the loss that the party in breach tried to avoid by breaching. Since breach of contract may cause direct and natural harm as well as consequential harm, the aggrieved party is entitled to claims for both unless the aggregate exceeds the loss that the party in breach can foresee at the time of the contract's formation.[50]

C. *The Malpractice of Punitive Damages*

There are many disadvantages of punitive damages for breach of contract. Punitive damages increase the risk of doing business and discourage people from getting involved in commercial transactions. Today in China enterprises with abundant funds and good reputations are very likely to be sued. Under certain circumstances, even for a breach arising from third-party negligence,[51] an enterprise may be required to pay an additional penalty beyond compensation for a loss. Where the breaching party is an enterprise with limited funds or a bad reputation, the aggrieved party often goes to court faced with the difficulty of enforcing a favorable decision. Enterprises without credit can easily avoid punitive damages by dissolving, while successful business organizations are compelled to become defendants. In the end such penalties may discourage business transactions instead of protecting them.

Punitive damages also encourage litigation. An example is found in *Yantai Development Zone v. China Fodder Import & Export Corp.*, heard by the Yantai Municipal Court in the Shandong Province of the People's Republic of China in 1994. The defendant was obligated by contract to send one cargo of fishmeal exported from Peru to Yantai before September 1, 1994. However, the cargo vessel did not arrive at Yantai until September 15, 1994, because the ship was in bad condition and the U.S. Coast Guard detained it for more than a

50. U.C.C. § 2-715(2); CISG, *supra* note 46, art. 74.

51. For example, *A* promises *B* to sell specific goods to *B*, and *B* promises to sell the same to *C*. Later, *A* fails to deliver the goods to *B*, and hence *B* cannot deliver to *C*. In this case, *B* breaches the contract with *C* because of *A*'s breach of the contract with *B*.

month for repairs in Hawaii.[52] The market price of fishmeal was rising, and the delay itself did not cause any loss to the plaintiff. However, another Chinese corporation, which bought the goods from the plaintiff, sued the plaintiff for the delay in order to obtain double-returned-earnest money.[53] Under these circumstances the plaintiff had to sue the defendant shipper. In the end, the lower court overruled the claim for double-returned-earnest money, and the plaintiff and defendant reconciled.

Penalties for breach of contract also frequently result in uncertain effects. In countries allowing punitive damages, the amount of damages for breach of contract depends not only on the amount of direct and consequential economic damages, but also on various factors including harm to reputation,[54] the fault of the breaching party[55]—willful breach or negligent breach, and the financial situation of the breaching party.[56] This formula contributes to the uncertainty of remedies.

IV. CONCLUSION

One reason currently advanced in China for the adoption of punitive damages following a breach of a native economic contract is that the planned economic system still plays an important role in the country's national economy. It is suggested that the most effective way to prevent breach of economic contracts and ensure the completion of scheduled economic plans is to punish the parties in breach.

A typical example is the provision of the RCPSABP[57] providing that a seller who has not delivered agricultural by-products shall pay the buyer damages amounting to between one and twenty percent of the value of the unperformed part of the contract. At the same time, the breaching seller shall return the benefit received from the resale to the state. The severe punishment and forfeiture are intended to ensure grain purchase by the buyer, which in the eyes of the legislature is primarily the state.

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52. The U.S. Coast Guard detained the vessel pursuant to the International Convention for the Safety of Life at Sea, and the International Convention for the Prevention of Pollution from Ships.

53. *See supra* note 9 and accompanying text.

54. *See, e.g., supra* part II.B.1.

55. *See, e.g., supra* part II.B.2.

56. *See, e.g., supra* part II.B.2.

57. REGULATIONS ON CONTRACTS FOR THE PURCHASE AND SALE OF AGRICULTURAL BY-PRODUCTS art. 17(1) (1984), *translated in* COHEN, *supra* note 14, at 65-66.

The system of punitive damages cannot guarantee the performance of contracts. To make contracting parties keep their promises, the key lies in the parties' credit. To vindicate its honor, a credible party will not go back on its word; to avoid becoming a defendant, it dare not repudiate the contract. Accordingly, the best means to guard against breach of contract is to develop security devices to guarantee the interests of the contractual party standing by the contract, to consummate a compensatory damages system in the contract field, and to ameliorate judicial organs and enforcement devices.