



International Distribution Institute

IDI CONFERENCE 2023

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RESTRICTIONS ON THE FREEDOM OF CONTRACT

To what extent can you trust that your distribution or franchise contract will not be reinterpreted or rebalanced by Courts?



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DISCUSSION PANEL

Penalty and Liquidated Damages Clauses: *Can they be declared null or readjusted by Courts?*

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Liquidated Damages Clause is a pre-estimation by the contracting parties, of the loss that may occur in future due to the breach of contract, which is supposed to be paid as “*compensation*” by the party responsible for the breach to the aggrieved party.

On the contrary, the **Penalty Clause** has nothing to do with estimation. A penalty clause obliges the breaching party to pay a pre-agreed amount of money to the aggrieved party, as a “*penalty*” regardless of the damages occurred. It is simply a punishment.



Penalty and liquidated damages clauses are often included in distribution contracts, and more often in franchise agreements.

Are those clauses always valid and effective?

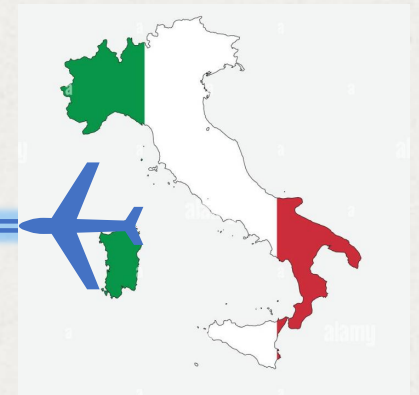
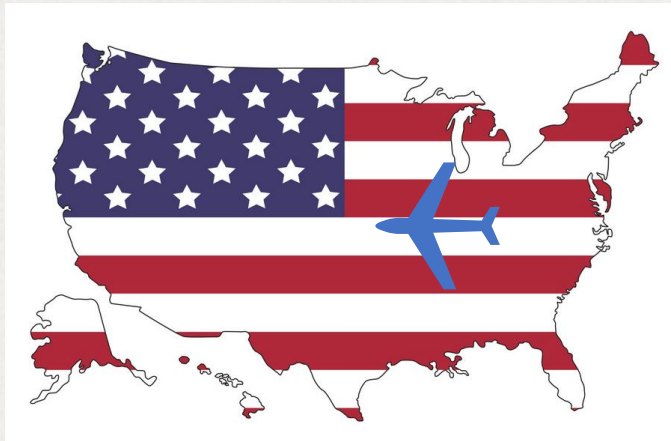
Can Courts intervene if they consider the amount not fair or the clause excessively unbalanced?

How should those clauses be drafted to avoid being voided by Courts?

We will try in this session to tackle these questions whether from a Common Law perspective or from a Civil Law perspective.



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U.S.A

- Not one jurisdiction, not one definition
- 50 states, plus territories
- The law differs – effort to summarize through Restatement Second Contracts, Sec. 356



Restatement Second Contracts

“Damages for breach by either party may be liquidated in the agreement but only at an amount that is *reasonable* in the light of the *anticipated or actual loss* caused by the breach and the *difficulties of proof of loss*.”

A term fixing unreasonably large liquidated damages is unenforceable on grounds of public policy as a penalty.”



State Differences

- California: statutory presumption of validity. Cal. Civ. Code Sec. 1671(b)
- Minnesota: invalid in franchise agreements. Minn. R. 2860.4400(J).



Sample Case

- *Crown Series, LLC v. Holiday Hospitality Franchising, LLC*, 851 S.E. 2d 150 (Ga. App. 2020).
 - Franchisee sold real estate without franchisor's permission.
 - Liquidated damages provision in agreement: monthly average for last 12 months x number of months remaining until franchisee had right to terminate agreement.



Sample Case, cont'd.

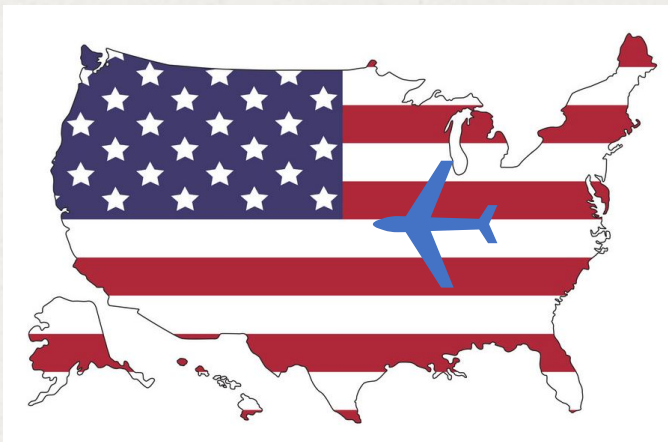
- Analysis:
 - Injury difficult to estimate accurately.
 - Intent to provide LDs and not penalty.
 - Reasonable amount.
- Outcome: Franchisee paid \$2,228,936 in LDs.

Sample Case 2

- *Howard Johnson Int'l Inc. v. HBS Family, Inc.*, No. 96 CIV. 7687 (SS), 1998 WL 411334 (S.D.N.Y. July 22, 1998)
 - Fixed amount of LD (\$2,000 per hotel room)
 - No reasonable relationship to the pecuniary harm likely suffered



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TURKEY

Specific regulation on penalty clauses (art 179 – 182 Turkish Code of Obligations)

- Penalty Amount = Minimum Amount to be paid in case of a breach
- Excessive Penalty Amount = Judge Intervention
- Merchants? Case law?

Regulation on General Terms and Conditions (GTC)

- Another instrument for tackling penalty clauses
- Franchise contracts as GTC?
- Proof regarding negotiation of clauses like the penalty clause
- Aggravating GTC even negotiated?
- Merchant?



TURKISH SUPREME COURT DECISION (11TH CHAMBER) 2022/1006, 10.02.2022

- Intervention of GTC
- Franchise Contract as GTC
- Effect of qualification as Merchant?
- Assessment of the penalty clause
 - Negotiation?
 - Any relevance to disclosure?
- Conclusion: Penalty or GTC regulation more of a safe harbour for the one suffering from a penalty clause?



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URUGUAY

SOURCE OF LAW

Penalty Clause as a Punishment

Section 1363 of the Uruguayan Civil Code regulates the “penalty clause” as an additional obligation in case of breach of contract.

It is typically an amount of money that debtor must pay, in case of breach of contract, as a punishment.

Compliant party can be entitled to receive actual damages plus the penalty clause if parties agreed on this type of clause in the contract.

Accumulation of damages and penalty clause is possible in this case



SOURCE OF LAW

Penalty Clause as Compensation

Section 1367 of the Civil Code, also defines this clause as the right the creditor has to receive damages as **compensation** for the breach of the principal obligation of a contract.

This “penalty clause” operates as a clause of liquidated damages. In this case, it is not necessary to prove by the creditor damages but only the breach of contract.

This clause entails a pre-approved liquidation of damages

It is not possible to accumulate this “penalty clause” with actual damages derived from a specific breach of contract.



Clauses in Distribution and Franchise Agreements

- There is no specific regulation on Distributionship and Franchise Agreements
- These contracts are covered by the principle of contractual freedom and general principles of contract law.
- Uruguay does not have a specific act for Penalty and Liquidated Damages clauses in franchise and distribution agreements.
- However, Penalty Clause, for delay in compliance of certain obligations, are common in franchise and distribution agreements.

Abusive Clauses

- Act No. 17.250 -*Consumer Protection Act*- Regulates abusive clauses.
- There are 2 type of Judgments in Uruguayan Jurisprudence: (i) abusive clauses can only be declared in adhesion contracts signed by consumers (ii) abusive clauses can be declared in all type of contracts due to direct application of General Principles of Contract Law.
- In Distribution and Franchise Agreements, local Courts have applied general principles and doctrines of contract law to identify abuses in the exercise of rights by parties.
- Courts use the Abuse of Rights, *e.g.* by taking advantage of a Superior or dominant position in the contract, to declare the nullity of an abusive clause or readjust it.



Court Decision No. 9/2011, 02/16/2011, Appeal Court of the 1st Circuit

- A Gas Company terminated a gas distribution contract with one of its distributors.
- Even though none of the parties was a consumer, and therefore Act 17.250 would not be applicable, the general principles applied as well.
- In this case, the gas distributor stated that the Gas Company changed the contract terms, and modified the way the profits were estimated
- The way of fixing the profits was objective, and the Gas Company illegally changed it to a subjective way.
- Certain clauses, including Penalty Clause, were declared null for the reasons stated.



Court Decision No. 20/2018, 14/02/2018, Appeal Court 3rd Circuit –*Prohibited Distribution*

- It was alleged that one party breached the contract by distributing a product without the corresponding authorization granted by Principal.
- Penalty Clause as punishment was set forth.
- Court resolved a reduction (adjustment) of the Penalty Clause to 10% of the original amount set forth by parties.
- Reasoning was excessive amount of Penalty Clause.