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Penalty clause: a useful tool, but to be used with caution

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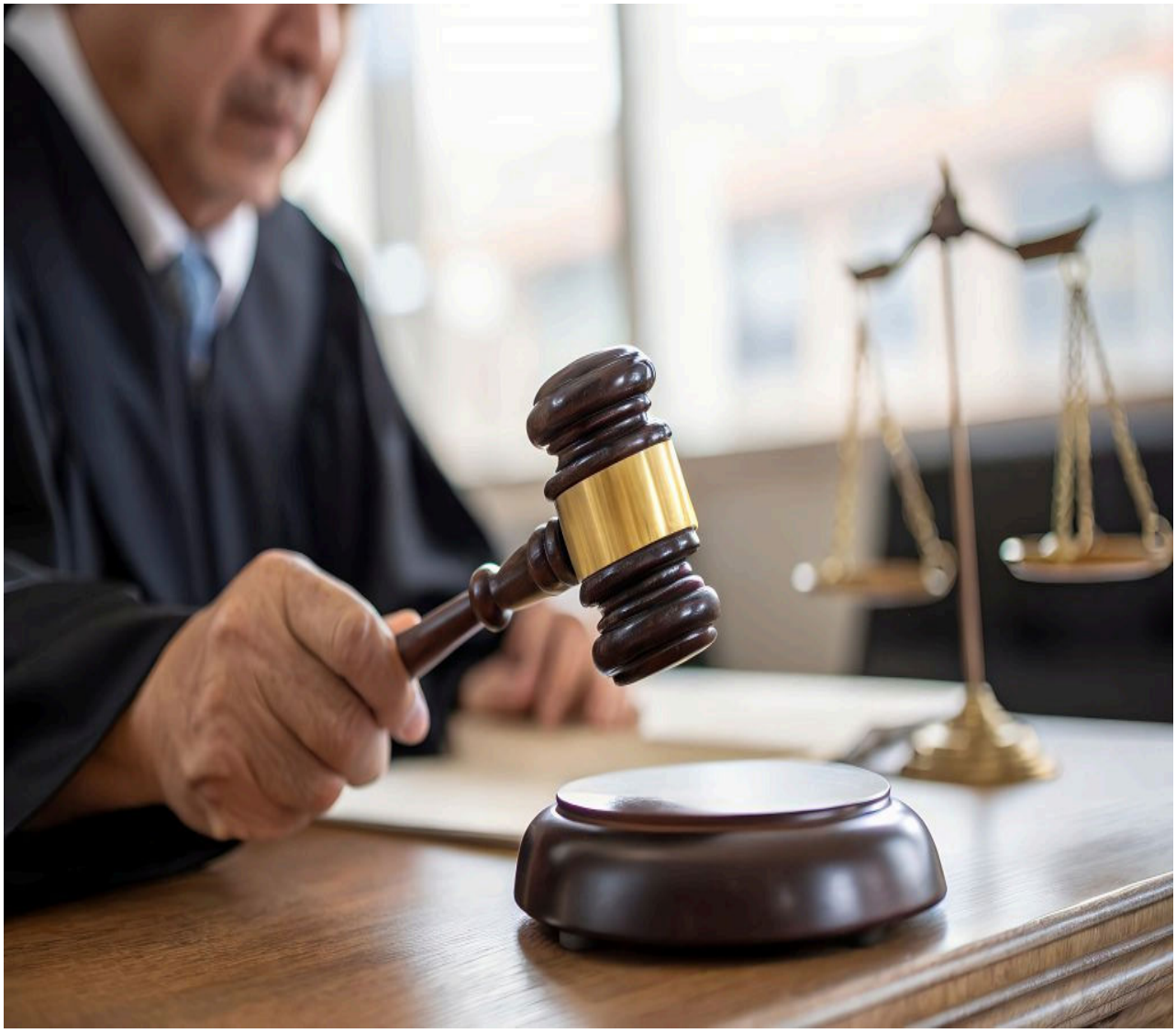
Case number KMU_today_010: The column by André Brunschweiler, lawyer and partner at the LALIVE law firm in Zurich, provides answers to legal questions that can and should concern Swiss SMEs.

André Brunschweiler, partner at the Lalive law firm in Zurich. (Photo: PD)

Imagine your company is investing in a new production line. Installation is contractually scheduled for early September, but the supplier is late. Commissioning is postponed, and with it, your deliveries. Or: You're conducting confidential discussions with a potential new business partner about a strategic collaboration—including market analyses, margin structures, and process expertise. But after signing an NDA, you learn that this partner is using your information to simply implement the project themselves—without you. The specific damage? Difficult to quantify and virtually unenforceable.

In such cases, a so-called contractual penalty can be an effective tool. This defines in advance how much a contractual party must pay in the event of a breach of contract – without the injured party actually having suffered or having to prove any (financial) damage. Fault is also presumed, which reverses the burden of proof: You don't have to prove anything to receive the penalty; rather, your contractual partner has to exonerate themselves in order to avoid paying.

The contractual penalty only lasts as long as the primary obligation. If the contract is voided – for example, due to a formal defect – the penalty clause also becomes invalid. Also important: including a contractual penalty in the general terms and conditions could render it ineffective – for example, if it is worded unexpectedly or unclearly. A transparent provision in the main contract is better.



The contractual penalty can shorten the legal process in the event of a dispute. (Symbolic image: Adobe Stock)

Judicial reduction in the case of a severe sentence

Freedom of contract generally allows the amount of the penalty to be freely determined. However, courts can reduce excessively high contractual penalties – but only if they are blatantly disproportionate to the breach of duty.

For example, the Federal Supreme Court reduced a contractual penalty in one case from CHF 690,000 to CHF 170,000 – it found that the penalty was significantly too high, measured against the economic value of the main service.

Whether a contractual penalty is proportionate is assessed on a case-by-case basis and depends on various factors: the duration of the contract, the type and severity of the breach, the economic context, industry customs, and the parties' business experience all play a role. It's important to note that an excessive penalty is usually only reduced, not declared void. Therefore, if you want to play it safe, it's better to set the penalty somewhat higher – a later reduction is the lesser evil than complete ineffectiveness.

The contractual penalty generally replaces damages unless otherwise agreed in the contract. If it is foreseeable that the actual damages will be difficult to estimate, the possibility of additional damages should be expressly reserved in the contract. Additional damages can only be claimed if fault is proven.

Contractual scope for design

There is considerable scope for structuring contractual penalties. The penalty does not necessarily have to be the payment of a sum of money—it can also consist of the loss of a claim or a contractual right, such as the right to wages or compensation.

It is also advisable to clearly stipulate in the contract that payment of the penalty does not release the party from fulfilling the contract. Without such an explicit agreement, the penalty payment is, with few exceptions, considered a replacement for the service originally owed.

Enforcement – also an advantage in debt collection

A clearly worded contractual penalty can be considered an acknowledgment of debt under debt collection and bankruptcy law. This allows the creditor to directly request provisional relief in the event of a dispute. This provides SMEs with an efficient debt collection tool in practice.

Be careful with foreign contracts – especially English law

What is permissible in Switzerland is not always the same internationally. Under English law, so-called "penalty clauses" are generally unenforceable. Only "liquidated damages," i.e., realistically estimated, predetermined amounts of damages, are permissible. A fixed contractual penalty without a clear reference to the actual damage is considered unlawful there. For SMEs with international partners, the choice of law clause is crucial – and in case of doubt, Swiss law should be agreed upon.

Conclusion

A contractual penalty is a proven tool for enforcing contractual obligations, mitigating evidentiary difficulties, and reducing debt collection risks. It has preventive, repressive, and procedural effects—provided it is cleverly designed.

Lalive

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