Contract law fundamentals

How the position differs across Europe

- Introduction
- Is a duty of good faith implied into the performance of commercial contracts?
- What does “good faith” mean?
- What is the meaning of “reasonable endeavours”?
- What is the meaning of “best endeavours”?
- Is there a difference between a “warranty” and a “representation”?
- Is it important to include an “entire agreement” clause in commercial agreements?
- What losses are recoverable at law following a breach of contract?
- What is a common B2B liability position?
- What are the perceived advantages of an indemnity?
- What do we need to look out for when agreeing liquidated damages provisions?
- About Osborne Clarke

Welcome to our overview of contract law fundamentals.

We hope you find this guide helpful. The aim is to explore a number of important contractual issues under English law and compare the position in France, Germany and the Netherlands.

There is an important distinction under English law between a warranty and a representation – but what is the position in other European territories? Does the same distinction apply under German law, with the same consequences for remedies? Is a duty of good faith implied into commercial contracts in France and the Netherlands – and, if so, does this duty apply during the negotiation period? In this interactive document, we explore these issues and more.

If you have any questions, please feel free to contact the team of specialists in the jurisdictions listed.

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Introduction

Is a duty of good faith implied into the performance of commercial contracts?

What does "good faith" mean?

What is the meaning of "reasonable endeavours"?

What is the meaning of "best endeavours"?

Is there a difference between a "warranty" and a "representation"?

Is it important to include an "entire agreement" clause in commercial agreements?

What losses are recoverable at law following a breach of contract?

What is a common B2B liability position?

What are the perceived advantages of an indemnity?

What do we need to look out for when agreeing liquidated damages provisions?

About Osborne Clarke

UK

There is no general duty of good faith implied into all commercial contracts.

But a duty of good faith will be implied into relational contracts. These are long term contracts where the parties are committed to collaborating with each other and where they put trust and confidence in each other such as JVs, franchise agreements, and long term distribution agreements – there is the potential for other agreements to be deemed "relational".

France

There is an explicit duty of good faith in all commercial contracts by virtue of article 1104 of the Civil Code, and this duty applies to all contracts of any nature which are subject to French law.

The duty of good faith applies to all stages of a contract's life from negotiation to execution and performance. This duty is part of a public order which means that it cannot be waived by parties contractually.

Contracting parties are presumed to be acting in good faith. The burden of proof in relation to breach of the duty of good faith lies with the claimant.

Germany

A duty of good faith is implied into all contracts as a matter of statutory law.

The Netherlands

Good faith forms a general principle that applies to all types of legal relationships and contracts, even to the pre-contractual and negotiation stage.

A party to a contract cannot enforce a contractual obligation or right if it would be considered unfair or unreasonable to do so under the circumstances.

Introduction

Is a duty of good faith implied into the performance of commercial contracts?

What does "good faith" mean?

What is the meaning of "reasonable endeavours"?

What is the meaning of "best endeavours"?

Is there a difference between a "warranty" and a "representation"?

Is it important to include an "entire agreement" clause in commercial agreements?

What losses are recoverable at law following a breach of contract?

What is a common B2B liability position?

What are the perceived advantages of an indemnity?

What do we need to look out for when agreeing liquidated damages provisions?

About Osborne Clarke

UK

Good faith does not simply mean "honesty". It means refraining from conduct which would be regarded as commercially unacceptable by reasonable and honest people.

Transparency, co-operation, trust and confidence are implicit.

France

No standard definition of good faith has been provided by statute or case law. If we were to attempt a definition it would be "the duty to act as your counterparty can legitimately and reasonably expect you to act".

In practice, the notion of good faith is multifaceted and is determined on a case by case basis by the courts.

The duty of good faith covers a wide range of obligations that vary depending on the stage of a contract's life such as an obligation to co-operate, to act loyally, to ensure confidentiality, and to disclose information.

Germany

Acting in good faith means dealing in a way that would be ethically acceptable to reasonable and fair people and takes into account the interests of the counterparty.

Whether or not certain conduct breaches the duty of good faith will be determined on a case by case basis. There is an abundance of case law on the subject.

Depending on the circumstances, it can, for example, be considered bad faith to abuse bargaining power, to mislead in negotiations, to fail to meet expectations one has created for oneself, or to exercise a right abusively.

Some concepts originally based on the general duty of good faith have also been codified, such as a right to require adjustments, or termination, in the event of a fundamental change in circumstances for which neither party is responsible.

The Netherlands

The meaning of good faith is aligned with the principles of reasonableness and fairness, so a party must act reasonably and fairly towards its counterparty.

This applies during the negotiation period too, which means that a party which walks away from a transaction with a bidder at an advanced stage of negotiations (perhaps being aware much earlier in the tender process that it did not intend to proceed with that bidder) could be held liable for expenses incurred by the bidder in relation to the negotiation, as a result of the party failing to act in good faith. In exceptional circumstances, a party may also be held liable for loss of profits of its potential counterparty (though, in practice, compensation for breaking off negotiations is very rarely awarded by Dutch courts).

Dutch law gives a negative understanding of good faith: a person has not acted in good faith, if he knew, or in the circumstances ought to have known, the facts or the law on which his good faith depends. Under Dutch law, a party bases its good faith on certain facts or circumstances and if that party is ill-informed, then that party is considered not to be acting in good faith. The implication of this is that a party may be under a duty to investigate.

Introduction

Is a duty of good faith implied into the performance of commercial contracts?

What does "good faith" mean?

What is the meaning of "reasonable endeavours"?

What is the meaning of "best endeavours"?

Is there a difference between a "warranty" and a "representation"?

Is it important to include an "entire agreement" clause in commercial agreements?

What losses are recoverable at law following a breach of contract?

What is a common B2B liability position?

What are the perceived advantages of an indemnity?

What do we need to look out for when agreeing liquidated damages provisions?

About Osborne Clarke

UK

There has been a recent restatement of the meaning of "reasonable endevours": what would a reasonable and prudent person acting properly in their own commercial interest and applying their minds to their contractual obligation have done (to try to achieve the objective)?

Crucially, the obligor is not normally required to sacrifice its own commercial interests.

France

The concepts of reasonable endeavours and best endeavours are not recognised under French law.

Under French law, one uses *"obligation de résultat"* which translates as the obligation to obtain a certain result, or *"obligation de moyens"* which translates as the obligation to implement the means necessary to obtain a certain result.

References to "reasonable endeavours" or "best endeavours" in a contract subject to French law would in all likelihood achieve the same result. Both terms would likely be considered as an "obligation de moyens" because they are not absolute obligations requiring the relevant party to achieve a certain result but instead they require that party to implement a certain standard or means necessary to achieve such result.

Germany

There is no universal definition of the term "reasonable endeavours", but to analyse whether an endeavour is sufficient, German courts would take all circumstances into account, including the associated cost and effort, the state of the art where applicable, and the relationship between the required effort to achieve the goal and the importance of the goal itself.

The Netherlands

The term "reasonable endeavours" has no clear meaning under Dutch law. It can be considered to be part of the obligation to perform to "the best of one's ability".

Such an obligation will be interpreted in accordance with the so-called Haviltex-formula (based on settled case law), which is intended to fill any gaps in a contract based on the parties' intentions and reasonable expectations.

Introduction

Is a duty of good faith implied into the performance of commercial contracts?

What does "good faith" mean?

What is the meaning of "reasonable endeavours"?

What is the meaning of "best endeavours"?

Is there a difference between a "warranty" and a "representation"?

Is it important to include an "entire agreement" clause in commercial agreements?

What losses are recoverable at law following a breach of contract?

What is a common B2B liability position?

What are the perceived advantages of an indemnity?

What do we need to look out for when agreeing liquidated damages provisions?

About Osborne Clarke

UK

Best endeavours is more stringent than reasonable endeavours.

It may require the obligor to act contrary to its commercial interests and/or require expenditure by the obligor. In *Jet2.com v Blackpool Airport Ltd* the court held that an obligation on an airport to use best endeavours to promote an airline's low-cost services required the airport to open outside of its normal working hours (to accommodate the airline's early morning and late evening flights) despite the airport incurring a loss in doing so.

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Germany

There is no universal definition of the term "best endeavours". The analysis carried out by a German court would be similar as for "reasonable endeavours", but less weight would likely be given to an argument that a specific action was not required because it was too onerous.

The Netherlands

There is no concrete difference between "reasonable" and "best" endeavours. The interpretation of such terms depends on the circumstances of the case and the meaning of such terms will be determined by the court.

Introduction

Is a duty of good faith implied into the performance of commercial contracts?

What does "good faith" mean?

What is the meaning of "reasonable endeavours"?

What is the meaning of "best endeavours"?

Is there a difference between a "warranty" and a "representation"?

Is it important to include an "entire agreement" clause in commercial agreements?

What losses are recoverable at law following a breach of contract?

What is a common B2B liability position?

What are the perceived advantages of an indemnity?

What do we need to look out for when agreeing liquidated damages provisions?

About Osborne Clarke

UK

Yes, there is an important difference.

A warranty is a contractual assurance from one party to the other. Breach of a warranty gives right to a claim for damages… but not usually the right to terminate.

A representation is a pre-contractual statement which induces the other party to enter the contract. Use of the term in a contract is the repetition of a pre-contractual statement. If the representation is false, and induced the contract, the remedies for misrepresentation are available:

– Rescission: the contract is set aside and treated as if it never existed. The parties are put back into the position in which they were before the contract was made.

– And/or damages: which may be higher than damages for breach of contract, and are calculated on a different (tortious) basis.

France

The concepts of warranties and representations are not recognised under French law.

Instead, one of the key distinctions when drafting contractual obligations under French law is the distinction between "*obligation de résultat*" and "*obligation de moyens*" as outlined above.

Germany

German law does not distinguish between warranties and representations.

Rescission or termination are available for most breaches (albeit sometimes only where the counterparty fails to remedy the breach within a reasonable cure period).

However, there is an important distinction between two German law concepts that can be hard to express in the English language:

"*Gewährleistung*" is a statutory system of remedies which can be contractually modified. Some of these remedies are triggered only if the breaching party is negligent (or acting intentionally, which represents a higher level of responsibility under German law), while others are available even where the breach occurs with no negligence. These statutory remedies are often referred to as a "warranty" in English language drafts under German law.

"*Garantie*" implies unlimited, strict no-fault liability on the part of the breaching party. This is sometimes referred to as "representation and warranty" in English language drafts under German law.

Both "*Garantie*" and "*Gewährleistung*" can be translated into English as "warranty" and therefore additional wording is strongly recommended in contracts to avoid ambiguity.

The Netherlands

No, there is no clear difference between representation ("*feitelijke mededeling*") and warranty ("*garantie*").

The "representations and warranties" clause can be interpreted in two ways:

(1) as a contractual obligation of a party that the information provided is true and accurate; and/or

(2) as a contractual warranty (in Dutch: "*garantie*") that, if breached, will oblige a party to cover the damage caused.

Breach of either a representation or a warranty can entitle the other party to different remedies, being:

– Rescission of the contract based on error ("*dwaling*"); and/or

Either

(a) claim performance (which is often the remedy first sought under Dutch law); or

(b) terminate the contract based on non-conformity and/or default; and/or claim damages.

Introduction

Is a duty of good faith implied into the performance of commercial contracts?

What does "good faith" mean?

What is the meaning of "reasonable endeavours"?

What is the meaning of "best endeavours"?

Is there a difference between a "warranty" and a "representation"?

Is it important to include an "entire agreement" clause in commercial agreements?

What losses are recoverable at law following a breach of contract?

What is a common B2B liability position?

What are the perceived advantages of an indemnity?

What do we need to look out for when agreeing liquidated damages provisions?

About Osborne Clarke

UK

Yes, because without an entire agreement clause, there is a risk that statements made during negotiations, which are not included in the final agreement, may constitute additional terms or representations.

Such a clause generally consists of a number of different elements:

– Entire agreement statement: To prevent the presumption (that the written agreement contains all the terms of the contract) from being displaced.

– Exclusion of liability for misrepresentations: Most commonly a non-reliance statement, to prevent liability in misrepresentation arising, by creating a contractual estoppel.

– Express carve-out in respect of fraud: Not legally necessary but usually included.

France

Yes, it is advisable to include an entire agreement clause in order to prevent the presumption that other contractual terms might apply, such as general terms of sale or previous agreements entered into between the parties.

There is no standardised language used in order to achieve this result.

Germany

It does not hurt to include an entire agreement clause, but such a clause will not prevent a German court from drawing on statements made during negotiations to interpret ambiguous clauses or fill in gaps in the agreement.

In this way, it is harder to prevent pre-contractual statements from forming part of a written agreement under German as opposed to English law.

The Netherlands

The Dutch courts have ruled that an entire agreement clause has no special meaning under Dutch law.

Such a clause will not prevent Dutch courts from taking into account pre-contractual statements, and the parties' intentions and reasonable expectations before, during and after entering into a contract. But the intention of the clause will be taken into account by the court while considering arguments of both parties.

Introduction

Is a duty of good faith implied into the performance of commercial contracts?

What does "good faith" mean?

What is the meaning of "reasonable endeavours"?

What is the meaning of "best endeavours"?

Is there a difference between a "warranty" and a "representation"?

Is it important to include an "entire agreement" clause in commercial agreements?

What losses are recoverable at law following a breach of contract?

What is a common B2B liability position?

What are the perceived advantages of an indemnity?

What do we need to look out for when agreeing liquidated damages provisions?

About Osborne Clarke

UK

Not all losses that flow from a breach of contract are recoverable. The party in breach is responsible for:

– 1st limb (direct losses) – losses "arising naturally … from the breach of contract"; and

– 2nd limb (indirect losses) – losses which "may reasonably be supposed to have been in the contemplation of both parties at the time they made the contract".

This is a potentially enormous liability; and so parties seek to impose limitations.

There are a number of recent cases where all of the loss suffered by the claimant was held by the court to be a direct loss; and therefore the contractual exclusion of indirect loss did not restrict the claim.

France

French law distinguishes between direct and indirect damages. Only direct damages (being damages that directly stem from the contractual breach) are recoverable at law. The concepts of "consequential", "incidental", "special" and "punitive" damages are not recognised and would not be awarded by a French court.

A conservative approach is generally adopted. Unless the contract provides otherwise, French courts tend to limit recoverable damages to those material damages resulting directly and immediately from the relevant breach or failure of the counterparty. Typically, loss of business, loss of revenue and any consequential losses are deemed to be "indirect" and therefore not recoverable.

However, it is possible to define contractually what constitutes indirect and therefore non-recoverable damages. This approach is recommended to avoid argument later in court.

Losses which are recoverable under French law are often referred to as "indemnifiable" losses; and those which are "non-recoverable" as "non-indemnifiable". This does not mean that the losses are recoverable in the manner that they would be under an indemnity claim under English law.

Germany

Generally, all losses caused by a breach are recoverable by the innocent party, including loss of profits, loss of goodwill and other losses that might be considered "indirect" under English law. German law has no clear distinction between direct and indirect losses. Some limits apply, for example, legal fees can usually be recovered only up to the statutory amount.

However, as a general rule the innocent party must prove the amount of its loss. Under certain circumstances, a court can make estimates; and specific calculation methods exist for intellectual property infringements.

German law does not award punitive damages and, as a matter of law, German courts do not enforce foreign punitive damage awards.

The Netherlands

In the case of breach of contract, or tort, a party is entitled to compensation for those losses that are closely connected to and caused by the fact on which liability is based. This causal connection is established by weighing the nature of the liability (it being strict liability or liability based on negligence) and the damage, and whether the damage can reasonably be attributed to the fact at hand.

There is no predetermined calculation method for damages for breach of contract. A judge has considerable freedom to calculate or even estimate the damages and may include e.g.:

– financial loss;

– loss of profits; and

– reasonable costs incurred in order to (i) prevent and limit damage, (ii) assess the damage and liability and (iii) establish the claim in court.

Introduction

Is a duty of good faith implied into the performance of commercial contracts?

What does "good faith" mean?

What is the meaning of "reasonable endeavours"?

What is the meaning of "best endeavours"?

Is there a difference between a "warranty" and a "representation"?

Is it important to include an "entire agreement" clause in commercial agreements?

What losses are recoverable at law following a breach of contract?

What is a common B2B liability position?

What are the perceived advantages of an indemnity?

What do we need to look out for when agreeing liquidated damages provisions?

About Osborne Clarke

UK

1. Risks each party commonly accepts without limit:

– fraud/fraudulent misrepresentation;

– death/PI caused by negligence;

– liability that can't be excluded by law;

– confidentiality breaches (tend to resist unlimited liability for DP breaches; and breaches of applicable laws);

– wilful default and abandonment;

– some indemnities e.g. third party IP infringement; breach of anti-corruption clause.

Click here for Points 2-5 >

France

1. Liability for wilful misconduct, fraud, gross negligence, and/or liability for death or bodily injury (even in the absence of negligence) cannot be limited under contract. Any such limitation will not be enforceable.

Limitation of liability in the event of third party claims for IP infringement and breach of data obligations is possible but not usual in French contractual practice.

Germany

1. In standard-form agreements, liability can be excluded only to the following extent:

– liability must be unlimited for intent (which includes fraud), gross negligence, personal injury, and under mandatory statutes (such as the German Product Liability Act)

– liability can be limited to typical and foreseeable damage for simple negligent breaches of essential obligations

– liability can be excluded for simple negligent breaches of non-essential obligations.

(Note that unlike under English law, there are different levels of negligence under German law – including simple and gross negligence – and the term "negligence" describes not a specific type of unlawful conduct, but the level of responsibility for a consequence, whether that consequence is a breach of contract or damage caused to another person outside or independently of a contractual relationship).

The wording of limitation of liability clauses needs to follow additional formal requirements, and therefore legal advice in drafting is strongly recommended.

The Netherlands

1. Liability that cannot be excluded or limited:

– intent ("*opzet*"); and

– gross negligence ("*bewuste roekeloosheid*").

Limitation or exclusion of liability must never be contrary to good morals or maintaining public order, or unacceptable according to the standards of reasonableness and fairness.

Liability for confidentiality breaches and third party IP infringements are regularly unlimited.

Introduction

Is a duty of good faith implied into the performance of commercial contracts?

What does "good faith" mean?

What is the meaning of "reasonable endeavours"?

What is the meaning of "best endeavours"?

Is there a difference between a "warranty" and a "representation"?

Is it important to include an "entire agreement" clause in commercial agreements?

What losses are recoverable at law following a breach of contract?

What is a common B2B liability position?

What are the perceived advantages of an indemnity?

What do we need to look out for when agreeing liquidated damages provisions?

About Osborne Clarke

UK

2. Risks each party wholly excludes:

Commonly, all indirect losses are excluded (though may be expressly accepted in relation to an indemnity).

Other heads of loss may be wholly excluded depending on bargaining position such as loss of profit, revenue, data, wasted costs and anticipated savings.

Click here for Points 3-5 >

France

2. It is possible to define contractually what constitutes indirect damages under a particular contract and parties are advised to set out expressly what constitutes indirect and therefore irrecoverable damages when drafting a contract in order to avoid later argument.

To the extent that a cap on direct damage is included in a contract, such cap can be challenged in the courts if it "*substantially deflates the purpose of the agreement*" (please see point 3).

Germany

2. The position outlined in point 1 has also become standard for individually negotiated agreements, even though more stringent limitations are legally possible.

Depending on the parties' bargaining power, individually negotiated agreements may also contain:

– an exclusion of all liability for simple negligence;

– a cap on liability for simple negligence (often a percentage of "fees paid" or "fees paid or payable in the contract year in which the damage occurs", but also specified amounts); and/or

– a cap on liability for gross negligence (though this is less common).

The Netherlands

2. Liability generally excluded:

– indirect or consequential loss; and/or

– certain types of loss related to specific risks included in the contract that would be considered indirect under common law.

Please note that the concept of indirect loss is not defined under Dutch law, nor well developed in Dutch case law. Best practice is to specify in the contract exactly which types of loss are recoverable and which are excluded.

Introduction

Is a duty of good faith implied into the performance of commercial contracts?

What does "good faith" mean?

What is the meaning of "reasonable endeavours"?

What is the meaning of "best endeavours"?

Is there a difference between a "warranty" and a "representation"?

Is it important to include an "entire agreement" clause in commercial agreements?

What losses are recoverable at law following a breach of contract?

What is a common B2B liability position?

What are the perceived advantages of an indemnity?

What do we need to look out for when agreeing liquidated damages provisions?

About Osborne Clarke

UK

3. Limit/cap on remaining risks:

– aggregate agreement; and annual caps – both common.

– fixed monetary; fixed percentage of fees; "greater of" caps – all common.

4. Separate caps for specific losses:

– most commonly seen for loss or damage to property risks. May reflect insurance position.

– also seen for DP risks.

5. Expressly recoverable/expressly excluded losses:

Customer: best practice is to state any losses which can be recovered as express direct losses e.g. costs of selecting new supplier.

Supplier: best practice is to state any specific heads of loss which are irrecoverable.

France

3. It is important to note that tortious liability cannot be limited by way of contract.

It is possible to limit contractual liability for breach of contract under French law provided that such limitation does not "deflate substantially the purpose of the agreement". A limitation may be held to substantially deflate the purpose of the agreement if it results in the breaching party being exposed to no real sanction as a result of that breach. This concept is assessed by the courts on a case by case basis.

A liability cap which is equal to the amount paid during the prior 12 months is usual practice in agreements subject to French law.

4. Separate caps are becoming more and more common for data protection breaches.

5. There is no standard position in relation to losses which are expressly stated in commercial contracts as being recoverable, or excluded, and this is contract-specific.

Germany

The Netherlands

3. Common liability caps:

– aggregate agreement; and annual caps – both common.

– fixed monetary; fixed percentage of fees; "greater of" caps – all common.

– may reflect the insurance position.

4. Caps for specific losses:

– data protection risks (e.g. twice the normal cap).

– infringement of intellectual property rights (which is often uncapped).

Introduction

Is a duty of good faith implied into the performance of commercial contracts?

What does "good faith" mean?

What is the meaning of "reasonable endeavours"?

What is the meaning of "best endeavours"?

Is there a difference between a "warranty" and a "representation"?

Is it important to include an "entire agreement" clause in commercial agreements?

What losses are recoverable at law following a breach of contract?

What is a common B2B liability position?

What are the perceived advantages of an indemnity?

What do we need to look out for when agreeing liquidated damages provisions?

About Osborne Clarke

UK

There is a belief that claiming under an indemnity gives quicker, easier and fuller recovery than available for breach of warranty, because:

– once the relevant event occurs, the obligation to pay is enforceable by means of a debt action;

– the contract principles of causation and foreseeability do not apply to debt actions; and

– the indemnified party has no general duty to mitigate its loss.

But: case law is not consistent, and sometimes causation and remoteness may apply to an indemnity claim. Recovery under a particular indemnity will depend on its drafting and the context.

France

Indemnity clauses are not common practice under French law, and do not make recovery easier.

No specific course of action exists under French law as regards to the enforcement of indemnity clauses and the indemnified party would have to go through standard proceedings in the French courts to enforce an indemnity clause – as it would in order to enforce a standard contractual clause.

Germany

Depending on the drafting, an indemnity is often considered a guarantee under German law, implying no-fault liability on the part of the breaching party where – without this wording – statutory law would usually require at least negligence in order to trigger a damages claim. This means that, broadly, it can be easier to make a claim under an indemnity, which can be deemed to be a guarantee under German law, than under a standard contractual clause because there is no requirement to demonstrate negligence or default by the breaching party.

An indemnity obligation can also be drafted to:

– limit other defences the indemnifying party may have (for example, if made payable "upon first request", it has to be paid, regardless of any defences which may only be invoked in a lawsuit for repayment); and/or

– extend the recoverable loss (for example, market-rate legal fees instead of only the statutory fees).

The Netherlands

Indemnities are tools to allocate responsibilities absolutely, often without regard to culpability. An advantage is that the indemnified party will in most cases only have to show breach of the indemnity to recover all losses caused as a result. The wording of the indemnity determines the scope of losses that are recoverable.

There are no statutory rules governing indemnity clauses and precise drafting is therefore absolutely essential.

Introduction

Is a duty of good faith implied into the performance of commercial contracts?

What does "good faith" mean?

What is the meaning of "reasonable endeavours"?

What is the meaning of "best endeavours"?

Is there a difference between a "warranty" and a "representation"?

Is it important to include an "entire agreement" clause in commercial agreements?

What losses are recoverable at law following a breach of contract?

What is a common B2B liability position?

What are the perceived advantages of an indemnity?

What do we need to look out for when agreeing liquidated damages provisions?

About Osborne Clarke

UK

If a provision is found to be a penalty, it will be unenforceable.

A penalty is a contractual provision which imposes a detriment on the party in breach of a primary obligation which is out of all proportion (or extravagant or unconscionable) to any legitimate interest of the innocent party in the performance of that obligation.

When agreed by sophisticated commercial parties, of equal bargaining power, a liquidated damages clause does not need to be negotiated in minute detail, nor be an accurate pre-estimate of the loss suffered, in order to avoid being an unenforceable penalty.

Liquidated damages will likely only be held to be an unenforceable penalty if they are exorbitant or extravagant when compared with the greatest loss likely to be suffered.

France

French law does not draw a distinction between penalty and liquidated damages clauses.

A penalty or liquidated damages clause, a *"clause pénale"*, aims to ensure that the relevant party will perform the obligation as failure to do so will result in the payment of the penalty as a form of pre-determined damages.

This type of clause must be carefully drafted so that it is not considered to be a limitation of liability clause or a forfeiture clause (where a party can agree in advance to pay a certain sum in return for the right to disengage from an obligation or from an agreement before its performance).

This is of importance as a judge has the power to increase or decrease the amount of the penalty in a *"clause pénale"* that it deems either obviously insufficient or excessive, whereas in relation to a limitation of liability clause or a forfeiture clause, a judge cannot amend the level of the liability cap or the agreed sum but can only declare the clause void where the relevant conditions are met.

Germany

Contractual penalties are enforceable under German law, but are subject to reduction by courts if they are excessively high.

Liquidated damages must be based on a good faith estimate of what the typical actual damage would be.

Additional restrictions apply in standard terms: the breaching party must expressly have the opportunity to prove that the actual damage was lower than the liquidated damages (in which case the breaching party only owes the actual loss suffered).

The Netherlands

Both liquidated damages and penalty clauses are lawful. A penalty clause can be used (i) as an incentive to perform, and/or (ii) to liquidate damages.

Unless expressly agreed by parties, the following applies:

– the other party cannot invoke a penalty clause and at the same time request specific performance under the contract, unless the penalty clause only serves as a form of compensation for losses due to delays; and

– a party cannot claim (additional) damages on top of a penalty.

This means that a penalty clause will replace any claim for performance or damages unless the contract expressly states that the relevant party can claim damages in addition to the penalty.

However, penalty clauses and liquidated damages are still subject to the principles of reasonableness and fairness and may be limited by the courts. The party relying on a penalty clause must prove that there is an (attributable) breach of contract. The court can reduce the level of a penalty and parties cannot contractually exclude this mitigation by the court.

However, the threshold for mitigation by a judge is high and a judge may only use its ability to intervene sparingly.

Introduction
Is a duty of good faith implied into the performance of commercial contracts?
What does “good faith” mean?
What is the meaning of “reasonable endeavours”?
What is the meaning of “best endeavours”?
Is there a difference between a “warranty” and a “representation”?
Is it important to include an “entire agreement” clause in commercial agreements?
What losses are recoverable at law following a breach of contract?
What is a common B2B liability position?
What are the perceived advantages of an indemnity?
What do we need to look out for when agreeing liquidated damages provisions?
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