

# Research on the Application of Legal Rules for Punitive Breach of Contract Penalties from the Perspective of the Civil Code

Rui Xu\*

School of Law, Anhui University of Finance and Economics, Bengbu, 233030, China.

\* Corresponding Author

## Abstract

**Punitive liquidated damages have an important function as performance guarantees, and are of great value in maintaining contract stability, curbing malicious breaches, and creating a favorable trading environment. With the development of China's economy, punitive damages for breach of contract have been widely applied in transaction practice, leading to an increasing number of contract disputes. However, the Civil Code of China has established a penalty system for breach of contract, but it has not clearly defined the basic function of penalty and has not explicitly stipulated punitive penalty. The judicial recognition standards, scope of application, and judicial adjustment rules for punitive penalty are still unclear, and the application of judicial adjustment rules for penalty determined by judicial interpretation is chaotic, leading to difficulties in the application of punitive penalty in judicial practice, which is not conducive to the realization of the value of the punitive penalty system. Based on this, it is necessary to conduct in-depth research on the current judicial situation, clarify the difference between punitive damages and damages, optimize the application of punitive damages, clarify the judicial recognition standards and scope of application of punitive damages, prudently apply the judicial adjustment rules of punitive damages, unify the judicial judgment standards, and achieve the unity of contract freedom and substantive justice.**

## Keywords

**Civil Code, Punitive Liquidated Damages, Recognition and Application, Judicial Adjustment.**

## 1. Introduction

The existence of liquidated damages during the process from contract formation to contract performance has important value, helping creditors effectively prevent and resolve the risk of contract breach, and playing an important role in protecting the legitimate rights and interests of creditors. There are multiple functions of liquidated damages, and two different types of liquidated damages can be distinguished based on their different functions, namely compensatory liquidated damages and punitive liquidated damages. The penalty for breach of contract, which has the function of urging the parties to perform in good faith and providing performance guarantee and deterrence for the smooth performance of the contract, is a punitive penalty, while the penalty for breach of contract, which compensates for the losses caused by the non breaching party's breach of contract, is a compensatory penalty [1]. In recent years, with the further development of China's market economy, punitive damages with performance guarantee function and ensuring contract stability have been widely used by the public in market transactions, especially in commercial contracts, to reduce the risk of contract breach. Therefore, in judicial practice, the number of cases related to punitive damages continues to increase. However, at present, there is no specific and clear provision for punitive damages in China's legislation, which leads to differences and differences in the determination

and application of punitive damages by courts in different regions. The phenomenon of different judgment results in the same case is significant, which damages the authority and credibility of the law and is not conducive to reflecting judicial fairness and justice.

Article 585 of the Civil Code is a provision on liquidated damages and their adjustments, inheriting the relevant provisions of Article 114 of the Contract Law. The first paragraph stipulates respect for the independent will of the parties and allows them to agree that in the event of a breach by one party, they shall pay a fixed amount of liquidated damages to the non-breaching party based on the breach situation or calculate the amount of liquidated damages according to the agreed calculation method. The second paragraph stipulates the judicial adjustment rules for liquidated damages, authorizing the court or arbitration institution to increase or decrease the agreed liquidated damages that are lower or higher than the losses caused at the request of the parties. The third paragraph clearly stipulates that in the case of delayed performance, the defaulting party shall continue to perform the debt after paying the penalty for delayed performance. However, the current law does not clearly specify the specific types of liquidated damages. There are various opinions in the academic community on whether the liquidated damages stipulated in Article 585 of the Civil Code belong to punitive or compensatory liquidated damages, or whether both exist in this provision. The mainstream theory holds that the liquidated damages stipulated in Article 585 (1) of the Civil Code refer to the predetermined amount of damages and are compensatory liquidated damages. The judicial adjustment rules for liquidated damages stipulated in the second paragraph mainly apply to compensatory liquidated damages [2], while the third paragraph is about punitive liquidated damages. The reason for this viewpoint is that the law stipulates that in the case of delayed performance, the defaulting party not only needs to pay liquidated damages, but also needs to continue to perform the corresponding contractual obligations or obligations. The party who suffers losses cannot continue to request other damages and actual performance of contractual obligations after receiving compensatory liquidated damages [3]. There are also viewpoints that analyze from the perspective of the functions possessed by Article 585, and believe that the most important function of the penalty reduction rule in paragraph 2 is to fill the loss, without emphasizing the punitive function. Therefore, punitive liquidated damages are not regulated by this article. Scholars who hold the view of punitive liquidated damages argue that the nature of liquidated damages stipulated in Article 585 of the Civil Code is punitive. Scholars who support this view believe that the actual nature of compensatory liquidated damages is a rough estimate of the total amount of damages, and does not have the nature of liquidated damages. Only punitive liquidated damages are truly liquidated damages.

It can be seen that Article 585 of the Civil Code still provides abstract and vague provisions on the nature, function, and type of liquidated damages. On December 5, 2023, the Interpretation of the Supreme People's Court on Several Issues Concerning the Application of the General Provisions of the Civil Code of the People's Republic of China on Contracts was promulgated and implemented. In Article 65, it is stipulated that if a party requests a discretionary reduction in liquidated damages, the people's court shall use the losses stipulated in Article 584 of the Civil Code as the benchmark, take into account factors such as the contract subject, transaction type, performance situation, degree of fault, and performance background, and measure the party's request for a discretionary reduction in liquidated damages based on the principles of fairness and good faith and make a judgment. At the same time, the standard for determining liquidated damages that are excessively high is limited to 30% of the damages caused by exceeding the limit. It is worth mentioning that Article 65 (3) provides an exception to the judicial discretion rule for liquidated damages, which means that the malicious defaulting party's discretion request is not supported, which helps to create an honest and trustworthy market trading environment [4] and stabilize the market economic order. However, the legal provisions regarding the determination, specific application, judicial adjustment, and the

relationship with compensation for damages of punitive damages are still unclear. Not only is there controversy in the theoretical community, but there are also many disputes in judicial practice regarding whether and how to apply punitive damages. Court rulings vary, and those supporting the application of punitive damages believe that the application of punitive damages is a manifestation of respecting the autonomy of the parties, which is conducive to maintaining contract stability and forming economic deterrence against the defaulting party, and does not violate the principle of fairness. The judgment opposing the application of punitive damages believes that punitive damages lack clear legal provisions and strict application conditions, and cannot be applied arbitrarily. Moreover, compensation for damages has always been the main way to bear breach of contract liability. Even if the court supports punitive damages, the compensation function and guarantee function of the damages have not been clearly distinguished in their judgment documents [5], the judicial practice has established a model of equal application of penalty functions [6], believing that the same penalty has both guarantee and compensatory functions, supplemented by punitive measures, which can easily lead to judicial disputes to a certain extent. It is urgent to combine the theoretical basis of punitive damages and the judicial application of punitive damages after the implementation of the Civil Code to refine and clarify it, in order to promote its unified application in judicial decision-making, maintain contract freedom and judicial justice.

## **2. Empirical Study on the Application of Legal Rules for Punitive Breach of Contract Penalties from the Perspective of the Civil Code**

In order to comprehensively grasp the application of the legal rules for punitive damages under the perspective of the Civil Code, the "search term" was set to "Civil Code + punitive damages", "cause of action" was set to "civil cause of action", and "judgment year" was selected to "2021, 2022, 2023" through the China Judgment Document Network. A total of 2151 judicial judgment documents were retrieved, including 924 in 2021, 903 in 2022, and 323 in 2023. Although the number of cases has significantly decreased in 2023, there are still nearly a thousand cases related to punitive damages in 2021 and 2022, indicating that there is still a great practical need for issues related to punitive damages in judicial practice after the implementation of the Civil Code. This article will select two cases to discuss, summarize the focus of controversy, and summarize the problems of punitive damages in current judicial practice.

### **2.1. Typical Case Analysis**

#### **2.1.1. Shanghai Sales Company Sues Jin and Others for Infringing on Trade Secrets in a Dispute over Mediation Agreement**

A sales company in Shanghai is a well-known organic silicon production and sales company. Jin, a former executive, resigned and established a Qingdao company with three other people. After the establishment of a Qingdao company, Jin violated the confidentiality clause signed with the plaintiff and used the obtained and mastered technical formulas and processes to produce and sell infringing products by a Qingdao company. The plaintiff then filed a lawsuit with the court on the grounds that the defendant had infringed on trade secrets. During the trial, both parties signed a mediation agreement, and the defendant promised not to disclose or use the trade secret information developed and owned by the plaintiff, and not to sell infringing products. Otherwise, the defendant would compensate the plaintiff with a penalty of 10 million yuan for breach of contract. Afterwards, Jin violated the mediation agreement and infringed again. The sales company sued Jin and Qingdao companies to the People's Court of Pudong New Area in Shanghai, claiming that Jin's breach of contract seriously infringed on the legitimate rights and interests of the plaintiff. They demanded that the two defendants compensate the plaintiff for the breach of contract as stipulated in the mediation agreement. Jin believes that the plaintiff's actual losses are far lower than the agreed amount of liquidated damages, and requests a

discretionary reduction in the liquidated damages. The People's Court of Pudong New Area has supported the plaintiff's lawsuit request after trial.

The People's Court of Pudong New Area believes that the focus of the dispute lies in whether it is necessary to adjust the amount of 10 million liquidated damages already agreed upon by both parties in the mediation agreement. The Pudong Court believes that whether to adjust the penalty for breach of contract can be considered from the following four aspects: firstly, the autonomy of the commercial subject should be considered; Secondly, consideration should be given to whether there is a serious imbalance in the interests of both parties; Thirdly, the punitive nature of liquidated damages should be considered; Fourthly, punishment for intellectual property infringement should be considered. After comprehensive analysis, the court believes that the punitive penalty of 10 million yuan agreed upon by both parties is in compliance with legal provisions, reasonable in amount, and supported.

### **2.1.2. Dispute Case between Tian and Lanzhou Yufeng Company regarding Housing Sales Contract**

In 2016, Tian signed an industrial plant sales contract and supplementary agreement with Yufeng Company, which stipulated that Yufeng Company would sell a certain industrial plant located in Lanzhou City that it had developed and constructed to Tian for a total price of 3172000 yuan. And it is stipulated in the supplementary agreement of the contract that Yufeng Company shall apply for the Property Ownership Certificate to Tian before December 1, 2021. If it fails to fulfill the obligation to apply for the certificate on time, it shall be liable for breach of contract to Tian at a rate of 0.03% of the total house price for one day of delay. After the contract and agreement were signed, Tian had already paid the full purchase price as agreed, but Yufeng Company failed to obtain the property ownership certificate from Tian as agreed, which constitutes a breach of contract and should be held liable for breach of contract. Tian advocates that the penalty clause for delayed processing and delivery of the real estate certificate agreed upon by both parties in this case is intended to urge Yufeng Company to actively fulfill its obligation to handle the registration of real estate rights. It is a punitive penalty and should not be based on the occurrence of actual losses. The agreement on liquidated damages in the contract involved is fair and reasonable, and does not fall under the circumstances where the liquidated damages should be lowered as stipulated by law.

The focus of controversy in this case lies in whether Tian's claim for liquidated damages for delayed performance of the transfer of property ownership certificate as stipulated in the contract should be supported, whether the calculation method for liquidated damages as stipulated in the contract should be adjusted, and how to make such adjustments. In this case, the first instance court held that Yufeng Company had agreed in several supplementary agreements to handle the property ownership certificate for Tian, but had not yet processed it on time and had been in breach of contract, and should bear corresponding breach of contract liability. The court supported Tian's request for Yufeng Company to bear a penalty of 426153 yuan from December 1, 2021 to February 28, 2023, and did not reduce the amount of the agreed punitive penalty. The second instance court, on the other hand, deemed that the calculation ratio of the liquidated damages of 0.3% agreed upon by both parties on August 26, 2020 was significantly too high. According to Article 585 of the Civil Code and based on the principle of fairness, the calculation ratio of the liquidated damages of 0.3% agreed upon was adjusted to 1/10000, and the amount of the liquidated damages was revised to 141114.4 yuan.

### **2.2. Summary of Controversy Focus**

The focus of controversy in both of the above cases lies in whether high liquidated damages need to be supported and whether the defendant's judicial discretion request is established. However, the court ruling results are completely different, which to some extent reflects the problems of punitive liquidated damages in China. In the first case, the people's court held that

according to Article 585 of the Civil Code, it can be considered that punitive damages for intellectual property rights are included in the scope of liquidated damages and are a special manifestation of liquidated damages. The system of liquidated damages, although primarily aimed at compensating the non breaching party for losses, also recognizes punitive damages in practice. In this case, the defendant intentionally infringed upon the intellectual property rights of others, and the circumstances were serious. Therefore, even if the defendant requested a reduction in the amount of liquidated damages higher than the actual loss, the court did not support it. In the second case, the judge of the Intermediate People's Court of Lanzhou City believed that in response to the request of the defaulting party to reduce the liquidated damages, the liquidated damages should be compared with the actual losses of the parties. If the liquidated damages agreed upon by the parties at the time of signing the contract exceed 30% of the actual losses, it meets the "excessively high" requirement stipulated by the general law and can be reduced. Therefore, based on the principle of fairness and in accordance with Article 585 of the Civil Code, the court has made a discretionary reduction in the amount of liquidated damages. Even in cases of delayed performance, the court still denies the application of punitive damages in this case.

It can be seen that in the current judicial trial process in China, some courts do not support the lawsuit requests for punitive damages made by non breaching parties to the contract, while others support the punitive damages requests made by non breaching parties. There are significant differences and inconsistent standards in the trial results made by judges due to differences in court hierarchy and regions. In judicial practice, how to determine and apply punitive damages for breach of contract has always been a controversial topic.

### **3. Problems in the Application of Legal Rules for Punitive Breach of Contract Penalties from the Perspective of the Civil Code**

#### **3.1. The Criteria for Determining Punitive Damages Vary**

The Contract Code of the Civil Code does not provide clear provisions for punitive liquidated damages, and Article 585 and the latest judicial interpretations of the Contract Code do not make clear distinctions on the nature and types of liquidated damages. The academic community also has different views on this. Currently, there are various views in the academic community regarding the determination of punitive damages, with the widely accepted ones being the parallel liability theory, the comparative loss theory, and the subjective purpose theory. The theory of parallel liability is currently the mainstream view in academia. Scholars advocating this theory [7] believe that if the breaching party has a punitive nature, then the non breaching party's request for payment of liquidated damages, compensation for losses, or continued performance of the contract can be made to the breaching party, rather than having to choose between them. If the nature of the liquidated damages is compensatory, the request for payment of liquidated damages by the non breaching party and the request for compensation for losses or continued performance of the contract cannot be made simultaneously. If the request for payment of liquidated damages is made, no other way of assuming breach of contract liability can be proposed. Scholars who support the theory of loss comparison believe that the amount of liquidated damages agreed upon by the parties should be compared to the actual losses suffered by one party due to the breach. If it is higher than the actual losses, the nature of the liquidated damages is punitive. Although this theory is not widely recognized in academia, it is widely applied in judicial practice. In the case of a private lending dispute between Xinjiang Samsung Construction Group Co., Ltd. and Lu Jiayou and Xinjiang Zechang Investment Co., Ltd., the court adopted this theory to determine the nature of the penalty as punitive and affirmed it. Scholars who believe in the subjective purpose theory believe that the determination of the nature of liquidated damages should be based on the

subjective purpose of the parties to the contract when agreeing on the liquidated damages clause. If the subjective purpose at that time was to book compensation for damages, it was a compensatory liquidated damages. If it was to prevent the risk of breach of contract, create deterrence and pressure on the parties, and prevent malicious breach of contract, it was a punitive liquidated damages. If the subjective purpose of the contract is not clear, it must be determined based on the interpretation of the system, commercial customs, industry practices, or similar agreements by both parties. If it cannot be confirmed, it is presumed to be a compensatory breach of contract penalty [7]. In the case of a lease contract dispute between Xinjiang Shangpin Commercial Management Company and Xinjiang Friendship Company, the court adopted the subjective purpose theory, believing that the main purpose of setting up a penalty clause is to encourage the friendly company to fully and completely fulfill its contractual obligations, rather than based on actual losses. As long as Xinjiang Friendship Company breaches the contract, it should pay the corresponding penalty. Therefore, the court determined that the nature of the penalty for breach of contract in this case is punitive.

As early as 2009, the Supreme People's Court issued the Guiding Opinions on Several Issues Concerning the Trial of Civil and Commercial Contract Disputes under the Current Situation, which explained the nature of liquidated damages and theoretically distinguished between compensatory liquidated damages and punitive liquidated damages. However, according to case analysis, there is no clear standard for determining punitive damages in judicial practice. In handling judicial practice cases, courts in various regions make judgments based on the local trial situation and specific circumstances of the case, and the nature of the damages is unclear. Some courts even do not determine the nature of the damages, and only use the concept of "liquidated damages" in the judgment, and have made judgments on the amount of "liquidated damages". In the contract dispute between Toplanning Company and Zeng Ming, although the court supported the plaintiff's request for liquidated damages, it did not determine the punitive nature of the liquidated damages. Due to the different standards for determining punitive damages and the application of different theoretical perspectives by different courts, the application of punitive damages in practice is chaotic, and the results of judgments vary in different regions. This will have a certain negative impact on the authority of the law and the credibility of the judiciary, and is also not conducive to the protection of the rights and interests of the parties involved.

### **3.2. There Is Controversy over the Scope of Application of Punitive Damages for Breach of Contract**

There is no unified view in the theoretical community on the scope of application of punitive damages, and there is controversy over the scope of application of punitive damages. In terms of applicable subjects, some scholars agree with this view, that is, civil subjects apply compensatory liquidated damages, and only commercial subjects apply punitive liquidated damages, because compared to civil subjects, commercial subjects have higher risk estimation ability and risk tolerance [8], and can fully anticipate contract risks. The amount of punitive liquidated damages agreed upon between commercial parties is determined through reasonable judgment and should be affirmed. As for the breach of contract situations applicable to punitive damages, generally speaking, breach of contract situations include delayed performance, incomplete performance, and refusal to perform. Many scholars in the theoretical community believe that the provision of Article 585 (3) of the Civil Code is a statutory application of punitive damages, while there are different views among scholars on the nature of the penalties applicable to other breach situations. The author believes that there are various situations of breach in judicial practice, which are essentially breach of contract and should not be applied differently.

Due to the vague provisions in legislation, there is currently no consensus on the scope of application of punitive damages for breach of contract. In judicial practice, a dual model of "compensatory as the main approach and punitive as the auxiliary" has been formed [9], which believes that liquidated damages have both compensatory and punitive properties, but mainly compensatory. However, the application of this model in judicial practice faces many difficulties, especially in practice where most judges directly exclude punitive elements and classify liquidated damages as compensatory liquidated damages. In the case of contract dispute between COFCO Corporation and Jinyuhao Construction Group, the court ruled in the judgment that due to the fact that the liquidated damages of 500000 yuan stipulated in this clause were labeled as "punitive" by both parties, their nature conflicted with the basic attribute of "loss filling" of the liquidated damages, directly denying the application of punitive liquidated damages. It can be seen that in judicial practice, the application of compensatory liquidated damages is widely present in disputes over liquidated damages, gradually becoming a statutory type. Judges give priority to recognizing it as compensatory liquidated damages when trying cases. Even if the contract explicitly stipulates it as punitive liquidated damages, there are still negative situations, and the scope of application of punitive liquidated damages is not clear.

### **3.3. There Are Deficiencies in the Judicial Adjustment of Punitive Damages for Breach of Contract**

The judicial adjustment rules for liquidated damages are clearly stipulated in Article 585 (2) of the Civil Code, while judicial interpretations further recognize that the amount of liquidated damages exceeding 30% of actual losses is eligible for judicial discretion. Due to the excessive emphasis on the compensation function of liquidated damages in China's judicial practice, the digital penalty reduction model based on losses and easy to quantify has become the mainstream of current judicial practice [10]. The function and value of liquidated damages are almost identical to the liability for compensation for damages, resulting in the almost loss of the independent practical basis for the existence of liquidated damages. Even if the parties explicitly agree on punitive damages, under the current judicial discretion rules, the court generally adjusts them in reference to actual losses, making the punitive damages clause meaningless.

From a functional perspective, punitive damages have the functions of fulfilling guarantees and economic sanctions, have an economic deterrent effect, and exert psychological pressure to urge debtors to be honest, trustworthy, and fulfill their contractual obligations [11]. The contracting parties agree to agree on a high penalty for breach of contract, to prevent the other party from easily breaching the contract, to ensure the effective performance of the contract purpose, and to ensure the smooth performance of the contract. However, the current judicial adjustment rules for liquidated damages have weakened the performance guarantee function of punitive liquidated damages, allowing the defaulting party to request a reduction in liquidated damages based on the actual losses of non defaulting parties. In judicial practice, courts have repeatedly emphasized that if the amount of liquidated damages stipulated in the contract exceeds 30% of the actual loss and the parties request a reduction, most courts generally adjust the amount of punitive damages through judicial reduction, thereby denying the application of punitive damages and ignoring the important value of punitive damages. In judicial practice, due to the extensive application of judicial discretion rules for liquidated damages, the actual determination of punitive damages has been repeatedly hindered or prohibited. For example, in the civil loan dispute case between Xinjiang Samsung Construction Group Co., Ltd. and Lu Jiayou, Xinjiang Zechang Investment Co., Ltd., as well as the contract dispute case between Ningbo Jumei Film and Television Media Co., Ltd. and Focus Times (Beijing) Cultural Media Co., Ltd., although the court recognized the nature of punitive damages, it still made judicial adjustments to the liquidated damages and denied the excess amount based

on actual losses. The reason why the court did not reduce the punitive damages in the contract dispute case between Shenyang Zuchen Cultural Activity Planning Co., Ltd. and Feng Yusheng et al. is that the liquidated damages meet the expected benefits and the amount is not excessively higher than the actual losses. Based on the above cases, it can be found that in current judicial practice, due to the abuse of the judicial discretion rules for liquidated damages, the important role of the performance guarantee of punitive liquidated damages cannot be fully played, which seriously undermines the value and function of the punitive liquidated damages system.

#### **4. Suggestions for Improving the Application of Legal Rules for Punitive Breach of Contract Penalties from the Perspective of the Civil Code**

##### **4.1. Clarify the Criteria for Determining Punitive Damages for Breach of Contract**

The mainstream view in China to determine the nature of liquidated damages is that compensation is the main principle and punitive is the secondary principle. However, the author found through case studies that in practice, the determination of the nature of liquidated damages in court judgments is unclear. Some courts judge the nature of liquidated damages based on the calculation method agreed upon in the contract, while others believe that liquidated damages have both compensatory and punitive effects. The reason for this phenomenon is that the current law does not have clear provisions for punitive damages, and there is a lack of standards for determining punitive damages. There is no authoritative standard in both theoretical and practical circles, and the determination of punitive damages in practice mainly relies on the discretion of judges. In addition, the widespread application of the "loss comparison theory" in judicial practice has led to confusion between the penalty system and the compensation system for damages in many cases, resulting in the unique value of punitive damages not being fully realized. Therefore, it is necessary to define the criteria for determining punitive damages for breach of contract.

The author believes that the criteria for determining punitive damages can refer to the following aspects: first, the parties to the contract should have a clear agreement. The penalty system for breach of contract is a product of the autonomy of the parties to the contract. One of the most basic principles of civil law is to fully guarantee the autonomy of the parties, and the same applies to the determination of punitive penalty for breach of contract. Whether it is a commercial contract or a civil contract, the parties to the contract will fully estimate the risks and responsibilities they need to bear when agreeing on the penalty terms. Choosing to sign a punitive penalty is the result of the parties themselves expressing their intention. In judicial practice, if both parties to the contract clearly reach an agreement on punitive damages for breach of contract, the court should respect autonomy of will and define the nature of the penalty based on the true expression of intention of both parties to the contract, rather than blindly refusing to recognize the punitive nature of the penalty. The affirmative punitive penalty for breach of contract helps to facilitate the smooth performance of the contract and combat speculative behavior of malicious breach of contract. Secondly, the determination of punitive damages is not related to actual losses. The function of punitive liquidated damages is to maintain the stability of the contract, provide performance pressure to the debtor, and provide guarantees for the correct performance of the contract. The function of the compensation system for damages is vastly different from that of punitive damages for breach of contract. Therefore, punitive damages cannot be judged from the perspective of compensation for damages. In judicial practice, the determination of punitive damages should not consider the factor of actual losses, but should be based on the perspective of the function of liquidated damages. Finally, in cases where the nature of the liquidated damages cannot be determined, it



can be inferred as compensatory liquidated damages, as punitive liquidated damages are a mutually agreed upon agreement between the parties. If the punitive nature of the liquidated damages cannot be determined, the true intention of the parties cannot be determined. Based on the principles of fairness and balance of interests, it can be inferred as compensatory liquidated damages to balance the interests of creditors and debtors and maintain the stability of the contract order.

#### **4.2. Expand the Scope of Application of Punitive Damages for Breach of Contract**

Compared with compensatory liquidated damages, compensating for losses is not the only purpose of punitive damages. The more important purpose is to use reasonable legal relationships as a means to set debts beyond the scope of losses for the defaulting party, increase the pressure on them to fulfill their contractual obligations [12], and thus achieve the goal of ensuring full performance of the contract. The punitive nature of liquidated damages can provide a deterrent for debtors to not easily breach the contract and effectively regulate malicious breach behavior. In the legislative process, an increasing number of unilateral laws have incorporated punitive damages into the legal system. The scope and amount of punitive damages are constantly expanding, from the initial contract field to the infringement field, and from the property field to the intellectual property field [13]. The latest judicial interpretation of Article 65 (3) of the Contract Compilation of the Civil Code further clarifies that people's courts do not support requests for adjustment of liquidated damages for malicious breach of contract in the trial of cases. Therefore, it can be seen that punitive liquidated damages are increasingly receiving legislative attention. In addition, based on legislative experience outside the region, it can be seen that both legal systems recognize the application of punitive damages for breach of contract. Civil law countries recognize the legal nature of punitive damages and establish laws to regulate them. Article 1152 of the French Civil Code confirms the effectiveness of punitive damages for breach of contract, requiring that the damages be not reduced. Article 339 of the German Civil Code also emphasizes the enforceability of punitive damages for breach of contract. The common law countries no longer only advocate for efficient breach of contract, but gradually recognize the application of punitive damages in judicial precedents. The Supreme Court of the United Kingdom has established new standards for the application of penalty rules, allowing liquidated damages to carry more contractual obligations and perform guarantee functions [14].

At present, the Civil Code does not provide clear provisions for punitive damages for breach of contract. The mainstream view in the theoretical community is that the application of punitive damages is for delayed performance as stipulated by law, and the scope of application is not clear. In judicial practice, the scope of application of punitive damages is even narrower than that recognized by the theoretical community. Some courts also support the application of punitive liquidated damages, but in judicial practice, the majority of judges generally recognize compensatory liquidated damages. The author believes that the primary purpose of punitive damages is to prevent and deter debtors, and to reduce the probability of malicious breach of contract. During the process of contract performance, any breach of contract may be based on malicious breach rather than just delayed performance. Therefore, the application of punitive damages should not be limited to the case of delayed performance, but should be extended to all breach situations, and the applicable subject should not be limited to commercial subjects. Civil subjects can also apply punitive damages in specific situations. China can refer to the legislative experience of the two major legal systems and clarify the application of punitive damages through legislation, further expanding the scope of application of punitive damages, stipulating that punitive damages can be applied to all breach situations, and fully exerting the

performance guarantee function of punitive damages, urging debtors to be honest and trustworthy, and maintaining normal contract transaction order.

### **4.3. Improve the Judicial Adjustment Rules for Punitive Damages for Breach of Contract**

Currently, the legislation does not specify the judicial adjustment rules for punitive breaches, but only supplements the discretionary reduction of liquidated damages in the judicial interpretations issued. The views in the theoretical community are also inconsistent. In judicial practice, judges often adjust punitive damages based on the judicial discretion rules stipulated in Article 585 (2) of the Civil Code and judicial interpretations. Most judges have always regarded liquidated damages as a pre agreement for the actual losses of creditors, confused with damages, and formed a judgment approach of comparing the amount of liquidated damages with actual losses to apply the discretion rules [15]. The advantage of this approach is obvious, which is the convenience of judgment, reducing the pressure on judges to hear cases, and will have a subtle impact on the willingness and habit of judges to adjust liquidated damages, resulting in almost identical application of the rules for reducing liquidated damages and compensation for damages in judicial practice. The author believes that the agreement on punitive damages is the result of the agreement of both parties to the contract, and more importantly, its punitive and deterrent effect is not related to damage compensation. It is an additional payment beyond damage compensation and should not be reduced in principle. Judicial discretion on the agreed amount should be an exception principle and should be applied prudently.

In judicial practice, the exercise of judicial discretion rules for punitive damages for breach of contract is too active and inappropriate, which deviates from the original intention of the establishment of punitive damages. To a certain extent, it will also promote the breach of contract and breach of trust behavior of contract parties, resulting in an imbalance of interests among the parties. Therefore, the author believes that the judicial adjustment rules for liquidated damages should be improved as soon as possible, further distinguishing between punitive liquidated damages and compensatory liquidated damages, and applying different adjustment rules. The judicial adjustment of punitive damages should follow the principle of non discretionary reduction as the general and discretionary reduction as the exception. When applying the judicial discretion rules for punitive damages, consideration should be given to contractual freedom and substantive justice, rather than using a fixed quota model that leads to mechanical justice and substantive unfairness. It is necessary to fully utilize the discretion of judges to flexibly grasp the application rules for punitive damages, and to comprehensively consider factors such as degree of performance, degree of fault, debtor's breach of contract income, creditor's expected contract income, and moral interests while respecting the consent of the parties.

## **5. Conclusion**

Punitive penalty for breach of contract is a system based on the autonomy of the parties involved. It plays an important role in safeguarding the interests of non defaulting parties and maintaining the stability of contracts, and has its irreplaceable independent functional value. Although there is no explicit provision for punitive damages in the Civil Code of China, the application of punitive damages in transaction practice is becoming increasingly widespread, and the value of the punitive damages system is constantly recognized. There are also more and more contract disputes involving punitive damages in judicial practice. However, the view of determining punitive damages from the perspective of compensation for damages still widely exists in judicial judgments, and there are also deficiencies in the judicial adjustment rules of punitive damages. After analysis and research, the author believes that the determination of

punitive damages should prioritize the autonomy of the parties involved, starting from the perspective of the function of liquidated damages and not related to actual losses. Punitive liquidated damages should be based on the general principle of non adjustment and the principle of adjustment as exception, and the judicial discretion rules should be applied prudently to prevent the impairment of the performance guarantee and deterrent pressure function of punitive liquidated damages. Even if the amount of liquidated damages is too high, as long as there is no invalidity or revocability, the result of party autonomy should be respected and not reduced. At present, the Civil Code has come into effect and judicial interpretations of contract compilation have been introduced. However, the application of the legal rules for punitive damages should still be supplemented and improved through judicial interpretations to achieve uniformity in the application of the punitive damages system, unify judicial thinking, promote judicial fairness, and achieve substantive justice in contracts.

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