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Securing obligations through the institute of contractual penalties

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Abstract

This paper examines the intricacies of legal processes related to the execution of promissory note rights, encompassing acts such as acceptance, transfer, guarantee, protest, payment, redemption, enforcement, and limitations concerning promissory notes. A comprehensive understanding of these procedures supports the effective application of this structured, abstract legal tool, which holds significant value in contemporary legal practice. Promissory notes, as unique financial instruments, are governed by specific legal frameworks which contribute to their precision and robustness, ensuring that they continue to serve as a reliable means for securing financial obligations. This study delves into the theoretical underpinnings and the practical implications of promissory note regulations, tracing their historical evolution and examining current applications in various legal systems. Furthermore, the analysis addresses the interaction between promissory note law and related securities laws, providing insights into how these frameworks support enforceable financial commitments. By detailing the rights and responsibilities inherent to promissory note transactions, the paper highlights the enduring relevance of this legal tool in the assurance of contractual obligations. Through this exploration, the paper aims to underscore the importance of a nuanced understanding of promissory notes relating to economic stability and legal certainty within domestic and international financial operations.

Keywords: bill of exchange, contractual penalty, security for obligations, contractual obligation

1. Introduction

The origins of the bill of exchange as a legal instrument date back to the early medieval period and are closely related to the existence of obligation relationships in which property sub-contract was exchanged. In the 12th and 13th centuries, the institution of the bill of exchange, i.e. the bill of exchange, was created, by which merchants solved problems related to transferring money over long distances. These bills of exchange took the form of promissory notes. In the 13th century, bills of exchange appeared, which were already like foreign bills of exchange and contained payment orders from the drawers of a certain person named in the instrument **[1]**. The law of bills of exchange developing in the 13th century, influenced above all by maritime trade, had the character of customary law and did not provide sufficient legal certainty for its users.

The codification of the law of bills of exchange first took place in Silesia in 1672 and 1712, and it was not until the 18th century that bills of exchange were issued for the first time by the states (Lower Austria, Silesia). The frequent circulation of international bills of exchange in the 19th century necessitated a gradual unification of the rules on bills of exchange, and three main developmental areas of bill of exchange law emerged in Europe (French and English areas). The third circle of the Austro-Hungarian law, regulating the principle of abstractness of promissory obligations from the extra-promissory case and promissory strictness, established the way of perception of this institute, which is still valid in our conditions today. In the territory of the Czech Republic today, the first regulation of the law of promissory notes was the Lower Austrian Bill of Exchange (Směnečný řád Dolnorakouský) of 10 September 1717, which was the basis for the promissory note patent of 1 October 1763 issued under Maria Theresa. It was based on the then customary law of promissory notes. In Europe, the fragmentation of the legal regulation of bills of exchange was particularly problematic. This fact is well illustrated by the fact that at the end of the 19th century, there were 56 different laws regulating this issue in the territory of the then Germany alone. Since 1850, by the Imperial Patent No. 51/1850 r.z., a new bill of exchange law was introduced in Austria, which, thanks to the retention of Austrian bill of exchange law, was in force in Czechoslovakia until 1928. Not very successful efforts to unify the bill of exchange law were successively made at the conferences in Leipzig (1847), Nuremberg (1866), The Hague (1910,1912), which were held in the Czechoslovak Republic in 1847. The breakthrough in unification was the 1930 Geneva Convention on Bills of Exchange.

The Slovak regulation of bills of exchange has been preserved so far in the original law reflecting the unifying Geneva bill of exchange conventions. The adoption of the law dates back to 1950 with effect from 1 January 1951. The above-mentioned absence of recodification links the two legal arrangements. This shows that the two Acts are significantly similar, since during the independence of the States, the common basis has been altered by only a few amendments reflecting the needs and developments of the legislation. In terms of the duration of validity, the promissory note law, and not only the Slovak law, is one of the oldest and most durable laws by our standards, in terms of the total duration of validity and the minimum number of amendments. The amendments to the promissory note law brought only marginal changes, which did not affect the essence of individual institutes or the systematics of the law. The absence of more comprehensive amendments seems unprecedented, at least in the context of other 'ordinary' laws, which are often subject to amendment processes several times a year. The Slovak Promissory Note Act has been amended only three times in its entire period of validity. This may reflect the actual precision and quality of the drafting of the law or the unifying draft, but it may also be due to the inherent terminology and the specific substantive and procedural regulation of this area of law.

As far as the Slovak law is concerned, this has been done by Acts No 659/2007 Coll., No 492/2009 Coll. and No 438/2015 Coll. The first of the aforementioned acts reflects in particular the adoption of the euro. This Act amended Article I, § 48(2), where the original wording "the official discount rate of the State Bank of Czechoslovakia" was replaced by "the basic 1 Act No. 191/1950 Coll., on bills of exchange and cheques, as amended. 2 Act No. 659/2007 Coll., on the introduction of the euro currency in the Slovak Republic and on amending and supplementing certain Acts Art. VIII. 4 of the interest rates of the European Central Bank". At the same time, the Act is supplemented in the final provisions by Article 9a entitled "Transitional provisions effective from 1 January 2008", which concerns the issue of the changeover of the Slovak Republic to the euro. The provision defines the rules for bills of exchange with absent currency of payment which were issued before the introduction of the euro in the Slovak Republic and are also payable in Slovakia. For these bills of exchange, a presumption is established that the bill was issued in Slovak crowns. It also regulates the issue of bills of exchange issued in Slovak crowns after the changeover to the European currency, their conversion and rounding. The third paragraph concerns bills of exchange issued in Slovak currency with a law other than Slovak law. The second amendment introduced a change to Article III. § 8(2) was deleted. In the original wording: 'The provision of Section 4(3) of the Act remains unaffected. No 43/1948 Coll., on agricultural credit. The purpose of the last amendment to the Bills of Exchange and Cheques Act, Act 438/2015 Coll., was to increase consumer protection in court proceedings before the general courts in the Slovak Republic. The proposed legislation is intended to prevent further abuse of certain legal institutions (e.g. promissory notes) against consumers and to ensure that judgments confirming creditors' claims amounting to usury are no longer issued. The above legislation reflects the requirement of EU legislation and the case law of the European Court of Justice, which provides for an ex officio obligation of courts to always consider consumer protection, an obligation that is often overlooked in judicial practice. The law introduces an express verbis obligation for the court to examine whether, in the context of a claim under a bill of exchange, the bill of exchange did not arise out of a relationship with the consumer.

Act No 191/1950 Coll. The Bills of Exchange and Cheques Act is lex specialis in relation to private law legal codes, having a privileged position among other special legal provisions even if their subject matter consists of similar institutions. In the absence of certain aspects of the bill of exchange issue in the Act, the general regulation set forth in Act No. 40/1964 Coll., the Civil Code, or, in the case of the commercial law nature of bill of exchange relations, Act No. 513/1991 Coll., the Commercial Code, shall apply to the arising relations.

Jurisdiction in Bill of Exchange Disputes and Cheque Disputes

Jurisdiction in disputes relating to bills of exchange, cheques or other securities, including disputes relating to bill protests, shall be

a) the Bratislava III Municipal Court for the district of the Regional Court in Bratislava,
b) the Košice City Court for the district of the Košice Regional Court,
c) the District Court of Banská Bystrica for the circuit of the Regional Court in Banská Bystrica,
d) the District Court of Nitra for the district of the Regional Court in Nitra,
e) the District Court of Prešov for the circuit of the Regional Court in Prešov,
f) the District Court of Trenčín for the district of the Regional Court in Trenčín,
g) the District Court of Trnava for the circuit of the Regional Court in Trnava,
h) the District Court of Žilina for the circuit of the Regional Court in Žilina.

The question is whether this proceeding should be oral or written, as its nature is more suitable for written consideration. In some cases, the discussion does not fully address the issue's essence. Typically, we might think of conflicts in which legal questions prevail over factual issues." **[2]**. "It is mainly about situations in proceedings where the facts are clear, such as in the issuance of a payment order, and in the case of the defendant’s disagreement, they have the simple option of filing an objection and having the decision annulled **[3]**.

2. Characteristics of the Promissory Note

The promissory note is one of the extremely specific institutions in Slovak legislation and other modern legal systems. Its legal definition is not explicitly regulated in the legal system of the Slovak Republic; following legal theory, it can be defined as negotiable security, the essence of which is the obligation of certain persons to pay the owner of the bill of exchange at a specified place and time the amount specified in the bill of exchange. It is unilateral, unconditional, abstract, and according to the promissory note's strictness, security is applied to the performance of a pecuniary obligation **[4]**. Although there is no statutory definition of a bill of exchange as such, based on the nature of a bill of exchange as a security, there can be certain definitional features in Act No. 566/2001 Coll. On Securities and Investment Services and on Amendments and Additions to Certain Acts (the Securities Act), which in Section 2 defines a security as a money-value record in the form and form prescribed by law, with which rights under this Act and rights under special laws are attached in particular the right to demand certain property benefits or to exercise certain rights against persons designated by law. A promissory note shall constitute a document on which a property right of a pecuniary nature is fixed, which may be exercised only based on that security. Both the claim of the holder of the bill of exchange and the obligation of the drawer of the bill of exchange are directly incorporated. The legal regulation distinguishes between two types of promissory notes: foreign promissory notes and promissory notes. The basic difference between a foreign bill of exchange and a promissory note is that a foreign bill of exchange contains an order to pay. Therefore, in addition to the drawer and the drawee, there is also a drawee (to whom the order is given). In contrast, a promissory note contains the drawer's promise to pay; therefore, the person ordered to pay is not mentioned (there is no drawer but only the drawer and the remitter).

The obligatory form of a bill of exchange is the written and documentary, expressed in Section 1 of the Bills of Exchange and Cheques Act. The term deed may be understood as any tangible substrate that meets the requirement of presenting a bill of exchange. § Section 1 also regulates other essential elements of a bill of exchange. A promissory note must contain the word "promissory note" in the instrument's body in its written language. The promissory note may be drawn in any language, but it must be one language, except for names and geographical indications. Nor is a combination of related languages permitted. Unconditional order to pay a certain sum of money; the name of the one who is to pay, the drawer or also the drawer of the bill of exchange, shall express the drawer's identification with the bill's text. It is, therefore, important that its placement should conclude the bill of exchange. This means, in practice, placing it below the text of the bill of exchange in the lower right-hand corner. The indication of the maturity date is a feature the bill may lack, in which case it is a promissory note according to Article I, § 2 of the BTS. However, if the maturity date is filled in, it may acquire only one of the four options listed in Article I § 33(1) of the BTC, namely:

- sight (sight draft): The creditor may present the draft on any business day. The day of presentation for payment shall be the date of maturity of the bill. The creditor need not inform the debtor of his intention to present the promissory note for payment. It is mostly used in connection with smaller sums of money for which there is a reasonable expectation of smooth payment.
- a specified period after sighting (time or term note): A term note gives the debtor a period specified on the note to pay after presentation. Thus, the exact due date is unknown at the time of issue. On acceptance of the bill, the date of acceptance or protest must be indicated as this is the date on which the time limit starts to run. This type of bill of exchange appears in transactions in foreign trade. Payment is linked to the delivery of the goods, and its time is almost impossible to determine precisely in some transactions.
- a certain time after the date of issue (dato bill): An example of such a maturity may be "I will pay seven days after issue".
- a certain date (fixed bill): The date may be expressed in the usual format and in a sufficiently clear description.
- an indication of the place where payment is to be made
- the name of the person to whom (remitter) or on whose behalf the payment will be made. A bill of exchange may not be issued as a bearer security.
- a date and place of issue of the bill of exchange: According to the judgment of the Supreme Court of the Czech Republic, file no. No. 29 Cdo 3106/2009, the day, month and year of issue of the promissory note may be expressed in any particular way if the date is possible. It is, therefore, permissible to express it in words, Roman or Arabic numerals or abbreviations.

In the judgment of the Supreme Court of Justice, Case No. 29 Odo 1645/2005, Article I, § 75, point 4 of the CCC was interpreted as meaning that the drawer of a bill of exchange undertakes to pay the bill at the place of payment and that the creditor has the right to demand performance at that place. Therefore, the place of payment is the place of presentation 13 of the bill of exchange and, where applicable, the place of protest. The place must be clear and certain and not be determined alternatively or inconsistently. The Supreme Court, in its judgment in Case No. 29 Cdo 3964/2007, concluded that it is sufficient if the place of payment is determined as a municipality or a town without further specification. This also applies if there are several municipalities with the same name.

The special features of a foreign bill of exchange are Unconditional orders to pay a certain sum of money. This is the feature in which a foreign bill of exchange differs from a promissory note. It is not a promise to pay but an order to the drawer to pay. Art. 1, § 1, point 2 of the CCC provides for two conditions for the command. Conditions can and often are part of the contractual relationship, but they must not be part of the bill of exchange. The amount of money on the bill of exchange may be specified in words, numbers or both words and numbers. Even possibly contradictory information between the verbal and the numerical expression will not invalidate the bill of exchange. According to Article I, § 6 of the BTS, verbal expression prevails in such a case. If a sum of money is expressed several times, either verbally or numerically, and is not identical, the smallest sum shall prevail. A currency and any existing currency must accompany the monetary amount. In the event of a contradictory indication of the currency, the instrument shall not be valid as a bill of exchange. Otherwise, the debt may be repaid in any freely convertible currency at the rate prevailing on the due date unless a different rate is specified on the note. The drawer may specify that he wishes the bill to be paid in the original currency using "effectively" or "in kind". An interest clause, if any, shall not invalidate the bill but shall be deemed not to have been written under Art. Interest on the amount on the bill is only allowed by law in the case of promissory notes and term promissory notes, as it is impossible to determine the maturity date in advance and, unless otherwise provided, from the date of issue of the bill. Name of the drawer/acceptor/receiver According to Section 3 of the BTS, the drawer is bound to pay only from the moment of acceptance of the bill of exchange. Where the drawer names himself as the drawer of the bill of exchange, it is a disguised promissory note. From the judgment of the High Court in Prague of 4 May 1999, Case No. 5 Cmo 657/98 (SR, No. 9/1999, p. 299): 'If the designation of the person to whom the promissory note is directed is indicated on the promissory note form in the usual place in the lower left part of the face of the note, it is the promissory note drawer, even if this indication is not explicitly quoted with the word "promissory note drawer".

A promissory note is a security for an order (order paper). The order quality of a bill of exchange is determined ex-lege, i.e. even if an order clause does not indicate the beneficiary of the bill of exchange. Normally, a bill of exchange is negotiable security, which is transferable by a rubbish (endorsable security). The provisions on endorsement under Art specifically provide the negotiability of a bill of exchange (negotiability). 11 et seq. The negotiability of a bill of exchange can only be excluded by a negative order clause (see § 11(2)), which makes the bill of exchange a so-called recto-security. The bill of exchange is no longer eligible for endorsement (transfer by endorsement). The negotiability can also be reduced by prohibiting further endorsement of the bill (see § 15(2)). Issuing a bearer bill of exchange is not permissible as it cannot be an au porteur paper. The person of the first beneficiary of a bill of exchange must always be indicated on the bill (cf. § 1 and § 75). Therefore, a bill of exchange (as opposed to a cheque) with the words "pay to the bearer, the holder of this bill" would be considered invalid.

3. Functions of a Bill of Exchange

The basic and key function of a bill of exchange from an economic perspective can be considered the payment function. The purpose of bills of exchange, from their inception, has been to be able to discharge a monetary obligation using them. During development, the payment function was supplemented by credit and security functions. The legislation does not explicitly provide for these functions, but their existence is implicit, like their use.

The payment function of a bill of exchange consists in the possibility for the debtor to fulfil his monetary obligation towards the creditor by issuing a bill of exchange. Issuing a bill of exchange does not extinguish the debtor's obligation to pay his monetary obligation but rather exists 'alongside' the bill of exchange obligation until payment is made. A promissory note can, therefore, be used in two ways: as payment by promissory note (promissory note pro soluto), which is payment of another obligation, and as payment through a promissory note (promissory note pro solvendo). When paying another obligation, the obligation's creditor becomes the promissory note's creditor. It is a kind of novation of the obligation, and the debtor gains time to fulfil it. With the consent of the creditor, of course.

The credit and escrow function of the promissory note is not directly paid. Still, instead of paying the amount due, the debtor issues a promissory note to the creditor and is effectively granted a short-term loan. In addition to the right to payment of the principal obligation, the creditor is entitled to interest on the amount owed on the promissory note. The promissory note may be used to deposit available funds short-term. The use of promissory notes in the context of consumer credit is a rather controversial topic. From the point of view of the protection of the consumer as the weaker party, it was also necessary to take measures in the bill of exchange law field. Currently, the legislation contained in Act No 250/2007 Coll. on consumer protection, which provides in Article 5a(1)(b) that it is inadmissible to secure the satisfaction of a claim or the fulfilment of an obligation under a consumer contract using a bill of exchange or a cheque **[5]**.

The security function should primarily motivate the debtor to fulfil his obligation properly and on time. Increased legal certainty increases the willingness of creditors to enter into commitment relationships. The security note secures the monetary performance until the primary obligation is discharged. Unlike the payment function, the security function of a bill of exchange does not have the payment of the bill as its primary purpose. It is intended to be a potential threat to the debtor if the debtor's debt increases if the obligation is not duly and timely discharged. Conversely, in the event of proper performance of the causal obligation, there should be no realisation of the rights under the reinsurance note. However, the purpose for which the bill of exchange was issued remains decisive for assessing its function.

3.1 Exercise of rights under a foreign promissory note

In enforcing rights under a promissory note, it is necessary to distinguish between the rights in rem on the note and the obligatory rights arising from the note. The rights under the promissory note, created in the scriptural act, can be divided into direct and indirect rights according to their content. Direct, unconditional rights, also called principal rights, can be exercised against the average of the promissory note debtors, i.e. the drawer of the note and its guarantor. Indirect, so-called punitive rights (recourse, intervention rights) arise only when a certain legal action of the creditor against another person has not met with a result. These obligations condition their existence on another legal fact.

The exercise of rights under a promissory note may be effected before and after its maturity. Before maturity, the enforcement of the rights arising from the penalty shall take place if the drawer has refused acceptance in whole or in part, and in cases of legally accepted uncertainty of property, such as bankruptcy, composition, execution carried out without success or if the drawer of the bill of exchange has forbidden the bill of exchange to be presented for acceptance. The penalty in the cases above shall be the right to payment of the penalty amount, payment of interest, if agreed; payment of six per cent interest from the due date; payment of the costs of protest and of the reports filed, as well as other costs and remuneration equal to one-third of one per cent of the amount of the bill of exchange or a lesser agreed amount.

Before the bill's maturity, the holder shall have the right of disposition to liquidate the bill. Purchasing a bill of exchange before maturity with the deduction of discount interest is called an escheat of the bill **[6]**.

3.2 Transfer of a Bill of Exchange

One of the reasons for using a bill of exchange in payment transactions is the possibility for the holder to transfer the bill of exchange; the ZZS allows for transfer in two ways. By endorsement - reverse endorsement (§ 11 of the Civil Code) or by a general civil law form of transfer, namely by assignment of the claim under §§ 524 to 530 of the Civil Code, the so-called assignment. The endorsement (reverse endorsement) results from the transferability of the promissory note to another person. The endorsement allows the transfer and, thus, the circulation of the bill of exchange. The endorsement is marked on the bill's reverse and signed by the person who transfers the bill by endorsement (endorser). After signing, the endorser guarantees to the person to whom he has transferred the bill and to any other transferee (endorser) that the bill will be accepted and paid. The endorsement has, among other things, a guaranteeing effect. The endorser may limit his guarantee by prohibiting, by a "not in line" clause, the further endorsement of the bill, also referred to as rectaindorsement. The bill is presented for payment to the direct debtor on the maturity date. However, only the holder may present the bill. The holder is the one who is legitimated by a continuous series of endorsements as the last endorser. The continuous series of endorsements is a warning for debtors who pay the amount of the bill of exchange when due to the original creditor without waiting to present it. This is because of the possibility of the promissory note changing hands and being presented to the debtor by someone completely different. In such a situation, the debtor must pay the promissory note amount twice. In case the drawer (drawee) refuses to pay, it is necessary to preserve the right to secure a protest within the legal time limit **[7]**. An endorsement is a written clause usually placed on the back of the bill of exchange. Therefore it is also referred to as an endorsement, but it can also be placed on a separate document called a pendant firmly attached to the bill of exchange. Usually, this method is used for a larger number of endorsements. It must be clear from the endorsement that it is a transfer of the bill of exchange rights, and the law does not prescribe the exact wording. A suitable wording is: "Instead of me - name, the surname of the endorser, the handwritten signature of the endorser". Other appropriate wording is: "Pay for me - name, surname of the endorser, handwritten signature of the endorser". The law does not allow partial endorsement, nor may it be subject to any conditions confirming the bill's abstract nature.

Promissory note guarantee A promissory note guarantee (aval) is a security relationship in which the promissory note guarantor (avalist) indicates its obligation in addition to some other person bound by the promissory note (avalatee). Any promissory note debtor (drawer, acceptor, endorser) may guarantee the promissory note. A promissory note guarantor secures the fulfilment of a claim arising from a promissory note obligation, whereby the guarantor is bound in the same way as the debtor it has guaranteed, except in the case of formal defects. The declaration of guarantee shall be made by a guarantee clause, which shall be expressed in the words "per aval" or other words with a similar meaning. The declaration shall be set out on the bill of exchange and shall be signed. The law allows the guarantor to guarantee only part of the amount of the bill of exchange, in which case he assumes the obligation only up to the amount of that part. Having more than one guarantor on a promissory note for more than one person and a single drawer is possible. The legal independence of the obligations of the guarantors is also reflected in the fact that the holder of the bill of exchange may exercise his rights under the bill of exchange against them in any order and, if several guarantors guarantee for one avalator, also against any of them. However, in the case of an acceptor or drawer of a promissory note, the condition of securing rights against the guarantors is the execution of a protest against their avalate.

4. The Nature and Importance of Security Institutes

The Slovak legal system currently offers us several security institutions as a certain private law guarantee, protecting the realisation of private rights and obligations. These are intended to help eliminate undesirable phenomena in private law obligation relations in the form of non-performance of agreed obligations. At the same time, they are intended to ensure the legal certainty of the creditor and to "force" the debtor to fulfil his obligation. **[8]**. At present, there can be found security institutes enshrined in Act No. 513/1991 Coll., Commercial Code, as amended, in the third part, Title I, Volume VI, Section 2, which regulates the security of obligations using security institutes, which are the contractual penalty, which will be dealt with in more detail in this paper, the guarantee, the bank guarantee and the acknowledgement of the obligation. The origins of security institutions can be traced back to Roman law. In Roman law, where the notion of obligation, "*obligatio*", originated, there are also notions relating to the debtor's default and the resulting liability **[9]**. The Romans further specified the causes, faults and consequences of default and damages. About the institutions which were to ensure the fulfilment of obligations, they knew of the right of pledge, the contractual penalty and others **[10]**. These security instruments enabled a creditor who did not trust the debtor's ability to strengthen his position considerably and, simultaneously, to enable his claim to be met using some security.

Under Roman law, a pledge was a right in rem which belonged to the creditor of a claim and allowed that claim to be secured by permanently setting aside a certain item of property from the debtor's assets in the event of the debtor's future insolvency **[11]**. Under Roman law, the lien strengthened the creditor's claim against the debtor by providing real security against everyone. It was an ancillary right that served to secure the claim secured by the action. It could arise and last as long as the claim existed and lasted, the transfer of the claim having the effect of transferring the pledge.

As it was then understood, the pledge does not differ in many respects from the present legal regime. This, too, is evidence of the sophistication of the law created, written down and applied in ancient Rome. As already mentioned above, Roman law also knew the institution of liability, while this institution was included in the category of 'secondary obligations'. Under Roman law, a suretyship was an agreement between a creditor and a third party, i.e. a guarantor (ad promissor), whereby the guarantor undertook, in addition to the debtor, to fulfil an obligation. In Roman law, a suretyship was usually established by a promise of stipulation, in which the guarantor assumed another's obligation. **[11]** It can be seen from that legislation that, despite the form of the creation of the guarantee, which is differently developed in the present legislation, the essence of the institution of the guarantee remains. If the creditor lacked confidence in the debtor, he had to supplement it, in his interest, with confidence in a third party, the guarantor. Roman law also provided for the institution of contractual penalties, as of the security institute. It fell into the category of so-called incidental benefits. In Roman law, it was enshrined under the name of "*poena conventionalis*". It was a promise by one of the contracting parties or an informal agreement between the contracting parties to pay a certain sum of money if one of the parties failed to fulfil its obligation under the contractual relationship at all or properly. Contractual penalties could be attached to a civil actionable bond and agreements between the parties that did not create a civil obligation or from which no obligation could arise. In addition to its punitive function, the *poena conventionalis* also had a reparative function, whereby the creditor did not have to prove whether and what damage had been suffered. It was sufficient for him to prove that the debtor had failed to perform. This contractual penalty was objective **[8]**.

The above-mentioned Roman regulation of security institutions can be regarded as fundamental, which, with variations, was passed on by the General Civil Code - Allgemeines bűrgerliches Gesetzbuch fűr die gesammten Deutschen Erbländer der Ősterreichischen Monarchie (General Civil Code) of 1811 and the Commercial Code (Code) of 1875 for the Hungarian part of the Austro-Hungarian Monarchy (Act of 1875 on the Commercial Code of XXXVII/1875 on Commercial Law effective from 1 January 1876) and has remained in the legal order of the Slovak Republic until today.

Currently, the legal regulations of contractual relations are scattered among several legal regulations. The regulation of security institutions can be found in private law codes. These are Act No. 40/1964 Coll., the Civil Code, as amended, and Act No. 513/1991 Coll., the Commercial Code, as amended.

The legal regulation exclusively in Act No. 513/1991 Coll., Civil Code, as amended, which is fully applicable to commercial obligations, regulates the pledge in § 151a - § 151m, the lien in § 151s - § 151v, the agreement on deductions from wages and other income in § 551, the security transfer of the right in § 553, the security assignment of the claim in § 554 and the security in § 555 - § 557.

The basic legislation in the Civil Code is supplemented or modified in the Commercial Code. The contractual penalty provided for in § 544 and § 545 of Act No. 40/1964 Coll. of the Civil Code, as amended, is supplemented by the provisions of § 300 - § 302 of Act No. 513/1991 Coll. of the Commercial Code, as amended. Legal regulation in both the Civil Code and the Commercial Code, but for the area of commercial obligations relations, their comprehensive regulation contained in the Commercial Code is exclusively applicable: liability § 546 - § 550 and recognition of obligation § 323. Legal regulation exclusively in the Commercial Code, which is also applicable for securing obligations that the Commercial Code does not govern, namely the institute of bank guarantee regulated in § 313 - § 322 of Act No. 513/1991 Coll., Commercial Code, as amended **[12]**.

The legal regulation of the security of commercial obligations aims to strengthen the economic or procedural position of the parties entitled under the obligation relationship. A higher degree of certainty and security in a particular commitment relationship is given by the fact that a new, secured relationship joins the original (basic) commitment relationship. The security relationship is a secondary, accessory legal relationship and can only arise alongside the primary legal relationship.
Security institutions strengthen the position of the creditor, and their basic functions are to ensure legal certainty on the part of the beneficiary, preventive consolidation of the creditor's position and responsible performance of the obligation on the part of the debtor, a reparative function, i.e. subsidiary satisfaction of the creditor, and a repressive function, which constitutes a form of punishment for non-performance of obligations **[13]**. As mentioned above, what is significant for the security institutions is their accessory and subsidiary nature. The principle of subsidiarity applies where the main obligation cannot be realised when a secondary security obligation secured by a person other than the debtor is used in support. The principle of accessibility represents the existential dependence of the securing obligation on the secured obligation. Unless the main obligation arises, the ancillary obligation cannot arise. In the case of extinction, the same is generally true.

5. Nature of Contractual Penalty

A contractual penalty may be defined as a financial consideration determined by an agreement, payable by a party to a contract which breaches the contractual obligation thus secured, irrespective of whether the creditor has suffered damage due to the breach of the obligation. The contractual penalty is regulated by Act No 40/1964 Coll. of the Civil Code as the first security institute in Sections 544 to 545a. It is one of the most widespread methods of securing an obligation. The legal regulation of contractual penalties provided for in the Civil Code is supplemented and modified by Act No 513/1991 Coll., Commercial Code, in Sections 300 to 302. The Civil Code is lex generalis on the institute of contractual penalty, while the Commercial Code is lex specialis. The Commercial Code objectifies the obligation to pay the contractual penalty. Unlike the Civil Code, its provision § 545(3), which prefers the contractual penalty as a sanction for a culpable breach of a secured obligation, the Commercial Code, in this provision, which is dispositive, establishes the principle that the obligation to pay the contractual penalty is not subject to circumstances which exclude liability for damages. Thus, even vis maior does not relieve the obliged party of the obligation to pay the contractual penalty, unless the parties have agreed otherwise **[14]**. This means that, in commercial relations, even the principle of force majeure does not exempt the debtor from liability to pay the contractual penalty agreed by the parties to the contractual relationship. The discretionary nature of the legal regulation of contractual penalties also gives the parties to the contract room to modify the relationship by their agreement. That is to say, the parties may agree that the creditor is entitled to payment of the contractual penalty only in case of a deliberate breach of the contractual obligation.

By fulfilling the preventive and protective functions of security institutions, the contractual penalty forces the debtor, under the threat of material damage, to fulfil its obligations under the agreed commitment properly and promptly. As a consequence of the debtor's failure to fulfil his obligation, the extent of his obligation is increased by the obligation to pay the agreed contractual penalty. The contractual penalty then acts as a sanction for the breach of the secured obligation, thereby fulfilling another of the basic functions of security institutions, namely the repressive, punitive function and, as a lump-sum compensation for the damage incurred, the reparative, compensatory function. The contractual penalty, like other security devices, is of an accessory nature and is thus linked to the existence of the main obligation that it secures **[15]**. A contractual penalty may be agreed upon both in the event of a failure to perform a contractual obligation at all and in the event of a breach of any other contractual obligation. This does not mean, however, that payment of the contractual penalty automatically extinguishes the obligation secured by it. Unless the parties agree otherwise, the debtor is obliged to perform the secured obligation even after its breach and payment of the contractual penalty.

The very enforceability and effectiveness of a contractual penalty, particularly for the performance of monetary obligations, is compromised by the fact that it is directly dependent on the solvency of the obligated party. This means that if the obligor defaults on its monetary obligation due to insolvency, it is likely that obtaining payment of the contractual penalty will be as difficult as obtaining payment of a monetary obligation. However, even in the case of pecuniary obligations, the contractual penalty is important, particularly in its preventive function. It puts effective pressure on the debtor to fulfil its obligation towards the party to the contractual relationship, thus avoiding further pecuniary damage.

The contractual penalty can also be seen as a lump-sum compensation for damages, as it compensates for the damage that has been or will be caused by the breach of the agreed obligation. As liquidated damages, liquidated damages relieve the liable party from proving and recovering damages from the obliged party. The obligation to pay the contractual penalty arises for the debtor from the moment of the breach of the obligation and not from actual damage. If one of the parties pays the contractual penalty, this does not release him from the obligation, and his obligation continues. However, it may be the case that the creditor and the debtor agree that the payment of the contractual penalty will discharge the obligation of the obligor to fulfil the principal obligation. In such a case, the contractual penalty replaces the principal obligation.

On the question of the limitation of the contractual penalty, it can be established that the claim for payment of the contractual penalty has its fate from its inception and is independent of the principal obligation. The limitation period runs separately for each day of delay. Determining the start of the limitation period of the primary right, i.e. the principal obligation, is, in principle, not problematic. The Civil Code states that the limitation period runs from the date the right could have been exercised for the first time. The Commercial Code ties the start of the limitation period to the date the obligation should have been performed or performance should have begun. Both codes, therefore, link the start of the limitation period to the moment the primary right is converted into a claim, i.e., the date the action can be brought before a court **[16]**. Neither the Civil Code nor the Commercial Code provides specifically for limitation in the case of contractual penalties. Thereby, it proceeds the basis of the general rules on limitation. The limitation period begins on the date the obligation is breached, the decisive factor being not the due date of the contractual penalty but the moment of the breach of the secured obligation. Doubts in practice as to the commencement of the limitation period of a contractual penalty arise not so much where the contractual penalty is fixed in a fixed amount but rather where it is fixed differently, as a percentage or linked to a different period of time. The case-law thinks that a secured obligation to perform properly and on time is breached repeatedly each day until the obligation is fulfilled. Each day of delay gives rise to a new right of the creditor to a contractual penalty, and each of those rights is separately time-barred. The courts have had to deal with the question of whether a right to contractual penalties arises even at a time when the secured obligation is already time-barred. In this respect, it is inclined to believe that the moment the legal obligation is breached and the contractual penalty is due, a new claim arises, which, however, has an ancillary relationship to the main obligation. Where the claim for payment of a contractual penalty arises out of a breach of an obligation which is not time-barred, the contractual term is subject to a separate limitation period. If the secured obligation is time-barred, a limitation objection may be raised against both the primary right and the right to contractual penalty **[13]**. The view that the debtor is in breach of its obligation to perform properly and on time every day for as long as the default continues is not shared. However, if the due date has passed, the debtor will never be able to pay on time but only in arrears. Equally, to perform properly means to perform only once at the agreed time, in the agreed amount, and in the agreed manner since any other performance is a breach of that obligation. This would mean that the right would not be time-barred, and the creditor would be entitled to the contractual penalty indefinitely, i.e. until the debtor has paid the principal due. It is considered that the limitation of the right to performance of the principal monetary obligation also results in the limitation of the right to a contractual penalty agreed for delay in performance of the principal obligation in the form of a specified percentage for a specified period of time (i.e. in an increasing manner for continuing delay), for the period of delay following the limitation of the principal obligation. Even in the absence of express legal regulation in the Civil Code and the Commercial Code, it can be inferred from the accessory nature of the contractual penalty that its fate is linked to the main obligation, not only on the termination of the main obligation, when the contractual penalty obligation also terminates, but also on the limitation of the main obligation. The Supreme Court of the Slovak Republic is also of the same opinion **[17]**.

The right to payment of a contractual penalty generally arises from the breach of the contractual obligation to which the contractual penalty is linked, and it is irrelevant whether and to what extent the breach of the obligation has caused damage. In the same way, as in other contractual obligations, the general provisions on extinction apply to an agreement on contractual penalties. The most common way of extinguishing a liquidated damages agreement will be performance. In practice, rescission, preclusion and an agreement to terminate a contractual penalty agreement are others. However, about rescission, it is important to point out the difference between the legal provisions in the Civil Code and the Commercial Code. In civil law, contracts are terminated ex tunt, i.e. from the outset, in the event of rescission. This means that even a claim for liquidated damages arising from a breach of a contractual obligation has never arisen. By contrast, the withdrawal from contracts concluded under the Commercial Code extinguishes the contracts ex nunc and the obligations which, up to the time of withdrawal, including the right to payment of a contractual penalty, remain unaffected. According to Article 302 of the Commercial Code, the withdrawal from the principal obligation does not extinguish the right to payment of the contractual penalty.

As regards the subject matter of the contractual penalty, based on the dispositive nature of contractual relations and the autonomous position of the parties to contractual relations, as well as on the fact that neither the Commercial Code nor the Civil Code expressly prohibits other than monetary performance in the form of a contractual penalty, the writer of this article thinks that the current legal regulation does not prevent the parties from agreeing that the contractual penalty will be expressed in non-monetary terms and will be in the form of other specified performance in kind **[18]**.

6. Essentials of the Contractual Penalty Agreement, the Indeterminacy of the Contractual Penalty Arrangement and its Legal Consequences

A written agreement is one of the formal prerequisites for entitlement to a contractual penalty. The obligation for the parties to agree in writing on a contractual penalty is laid down in Section 544 of Act No 40/1964 Coll. of the Civil Code and, since the above provisions on contractual penalty are lex generalis about the regulation contained in the Commercial Code, the requirement of a written form for the validity of the contractual penalty arrangement will also apply to commercial contractual relations. Under Article 40(1) of the Civil Code, it is void if a legal act has not been made in the form required by law or the parties' agreement. In this case, the so-called relative nullity within the meaning of Section 40a of the Civil Code will apply, and the legal act will be considered valid (with all legal consequences arising from it), unless the person for whose protection the ground of nullity of the legal act is intended (the beneficiary) invokes the nullity. If the beneficiary invokes the relative nullity of the legal act, the legal act is null and void from its inception (ex tunc). Failure to comply with the written form of the contractual penalty agreement and the payment of orally agreed contractual penalties cannot be effectively enforced in court. It is believed that by making the written form of contractual penalty agreements mandatory in private law contractual relations, the legislator intended to increase legal certainty in contractual relations and eliminate the need for proof in the event of a claim for payment of a contractual penalty.

An essential element of the contractual penalty agreement is determining the obligation to be secured. A secured obligation shall be understood as an obligation owed by one of the parties to the other party, the performance of which the parties have secured using a contractual penalty agreement. The fact that the determination of the secured obligation is an essential element of the contractual penalty agreement follows from the provisions of Article 544(1) of Act No 40/1964 Coll. of the Civil Code, as well as from the provisions of Article 37(1) of the Civil Code. The legal regulation contained in the provisions of Sections 544 and 545 of the Civil Code requires, in addition to the written form, a definition of the contractual obligation to be secured and an unequivocal agreement on the amount of the contractual penalty or the method of its determination for the contractual penalty to be validly agreed upon **[19]**. Thus, the absence of a definition of the obligation to be secured will result in the invalidity of the agreement on the contractual penalty due to its vagueness or incomprehensibility, which is an absolute nullity **[20]**. When formulating the text of the contractual penalty agreement, the parties must, therefore, take care to define precisely, definitely and comprehensibly the obligation the breach of which gives rise to the right to a contractual penalty.

As regards the assessment of whether the secured obligation may be both a pecuniary obligation (e.g. an obligation to pay the purchase price) and a non-monetary obligation (e.g. an obligation to complete the work on time), the answer to that question is clearly that the secured obligation may be both a pecuniary and non-monetary. It does not follow from any statutory provision governing contractual penalties that the law restricts the parties in this respect in any way, and, at the same time, in our view, the existence of such a restriction cannot be concluded by interpreting the relevant statutory provisions on contractual penalties. It is generally settled that a contractual penalty may secure any contractual or statutory obligation if that obligation is specified in the contract, including by reference to the relevant statutory provision from which that obligation arises.

Concerning the elements of a contractual penalty, the contractual penalty agreement must be viewed in terms of its content and not its title. It is not decisive how the parties refer to their agreement or whether they use the term 'liquidated damages' directly. Still, the content of their agreement is decisive in defining the mandatory elements of a liquidated damages agreement. A contractual penalty agreement linked to a certain contractually defined obligation may be agreed directly in the contract with the main obligation or in a separate document, which must clarify to which obligation it is ancillary and the performance of which it is intended to ensure.

6.1. Adequacy of the Contractual Penalty and the Court's Power of Moderation

The current legislation does not provide for the amount of the contractual penalty or the manner of its determination. Such a determination is impossible given the number of legal relationships and obligations the instrument secures and the autonomous position of the parties, who are left to regulate their obligations and security at their own will. In principle, however, the amount of the contractual penalty should not be disproportionately high, should reflect the value and importance of the obligation being secured, and should be regulated following good morals and fair dealing. The criteria for assessing reasonableness are highly individual and depend on the case. The personal, financial or social circumstances of the debtor whose contractual obligation is secured by the contractual penalty are not determinative of the amount of the contractual penalty **[21]**. The contractual penalty should not be a means of making an unreasonable profit and its amount should be determined primarily based on fulfilling its essential functions. The Commercial Code expressly provides that an unreasonably high contractual penalty may be reduced by the court, taking into account the value and importance of the obligation secured, up to the amount of the damage which has been caused by the breach of the contractual obligation to which the contractual penalty relates up to the time of the court's decision. The injured party shall be entitled to compensation for damages incurred afterwards up to the amount of the contractual penalty **[22]**. This is an exceptional, unusual right of the court to intervene in a commercial relationship of obligation. The court's moderation right is to punish cases where a negotiated contractual penalty leads to excessively harsh or unfair consequences that are judged unjustified to strengthen legal certainty and protect the weaker partner in the contractual relationship. This is particularly the case where there is a disproportionately harsh penalty on the debtor's part for breach of a contractual obligation and, on the contrary, on the creditor's part it is a simple source of extraordinary enrichment **[23]**. From the view of applying the court's right of moderation under the provisions of section 301 of the Commercial Code, the amount of the agreed contractual penalty at the time of the breach of the obligation by the other party to the contract is decisive. A contractual penalty agreed in the form of a fixed rate for a specified period of time, the total amount of which is the result of a long-term breach of the secured obligation by the debtor and the associated increase by an otherwise reasonable contractual penalty rate for a specified period of time, cannot be regarded as unreasonably high **[24]**.

Conclusion

The research highlights several key findings on contractual penalties' role and effectiveness in ensuring obligations' fulfilment. The author traces the historical roots of contractual penalties in Roman law and their evolution in modern legal systems, emphasising their widespread use in Slovak and European law.

One of the main findings is that contractual penalties serve multiple functions, including preventive (motivating debtors to comply with their obligations), protective (securing creditor rights), punitive (penalising non-performance), and reparative (compensating for damages). The research emphasises the accessory nature of contractual penalties, meaning they are dependent on the existence of a primary obligation, and their enforceability is subject to the solvency of the obligated party.

Another key finding is the discretionary power of courts to moderate excessively high penalties to ensure fairness and prevent unjust enrichment. The research also discusses the formal requirements for validly agreeing upon a contractual penalty, such as the necessity of a written agreement and clear identification of the secured obligation. Additionally, the research highlights the flexibility in determining the amount and nature of penalties while recognising the challenges in enforcing penalties when the debtor is insolvent.

Overall, the study underscores the importance of contractual penalties in enhancing legal certainty and protecting creditor rights. It also points out the need for balance and fairness in their application within commercial and civil legal frameworks.

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