

## Research on the System of Reducing Liquidated Damages

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**Abstract:** The system of discretionary reduction of liquidated damages, as an important institutional arrangement in modern contract law to coordinate autonomy of will and contractual justice, not only embodies the concept of contractual fairness but also relates to the scale and efficiency of judicial discretion. Article 585, Paragraph 2 of the Civil Code establishes the rule that "when the liquidated damages are too high, the people's court may make appropriate adjustments", granting judicial authorities the legitimate power to intervene in the autonomy of the contract when the liquidated damages are grossly unfair. This system, on the surface, responds to the demand for safeguarding transaction justice, but in essence, it has sparked numerous controversies and practical challenges: for instance, inconsistent judgment standards, ambiguous definition of the nature of liquidated damages, and unclear application standards occur frequently, which poses dual challenges to judicial practice in terms of both normativity and predictability. This article will explore the value basis of the legitimacy of the penalty adjustment system, and from the perspective of "functionalism", clarify its dual attributes of compensation and punishment. Based on this, it will improve the judgment and path of the reduction standard, promote the reasonable application of the penalty system, and enhance the fairness and standardization of judicial discretion.

**Keywords:** Adjustment of Liquidated Damages; Freedom of Contract; Contractual Justice; Punitive Liquidated Damages; Compensatory Liquidated Damages

### 1. Introduction

From the perspective of comparative law, the attitudes of the common law system and the civil law system towards the liquidated

damages system are different. The civil law system adopts the rule of reducing liquidated damages to limit excessively high liquidated damages, while the common law system uses the method of invalidating fines to deny the validity of liquidated damages higher than damages. If English law distinguishes liquidated damages into "damages for breach of contract" and "fines for breach of contract", and the nature of the liquidated damages is punitive, the court may declare them invalid and not enforce them. In contrast, civil law countries such as Germany, France and Japan have retained the system of adjusting liquidated damages, but have set relatively strict application thresholds. Article 343 of the German Civil Code stipulates that if the liquidated damages "significantly exceed the damage caused", upon the debtor's application, the court may adjust them. However, in practice, courts usually adopt a more restrained attitude and only exercise this right in extreme circumstances. Moreover, German law distinguishes between civil relations and commercial relations, stipulating that in commercial transactions, liquidated damages cannot be reduced. France and Japan also prohibit the adjustment of liquidated damages in principle, respecting the autonomy of the parties' will and emphasizing that the basis for adjustment is only when the liquidated damages are "obviously too high" and violate public order and good morals [1].

In contrast, the liquidated damages system in China's Civil Code takes an intermediate approach on this basis. It neither completely denies the legality of punitive liquidated damages nor comprehensively restricts their application, but rather grants courts the power to make appropriate adjustments at their discretion. The provisions of Paragraph 2 of Article 585 of the Civil Code are an inheritance and development of Paragraph 2 of Article 114 of the original Contract Law. In the original Contract Law, the application conditions for the

system of reducing liquidated damages were rather vague. It merely stated that "the parties may request the people's court or the arbitration institution to appropriately reduce them", emphasizing the granting of the "right to apply for reduction" to the breaching party. During the revision of the Civil Code, the legislative body made adjustments and modifications to the word order of the expressions, deleting the phrase "the parties may request the people's court or the arbitration institution to appropriately reduce it." One view holds that this adjustment to the Civil Code will help enhance the courts' ability to intervene in terms of grossly unfair contracts. Another viewpoint, however, is concerned that this move might undermine the principle of mutual consent of the parties, putting courts under tremendous pressure in fact-finding and loss assessment, and thereby reducing judicial efficiency. Furthermore, although the Civil Code has returned the rules for adjusting liquidated damages to the correct normative logic in terms of "legal policy" and "legal technology" [2], it still fails to approach from the perspective of the dual functions of liquidated damages and provide clear standards for distinguishing between punitive and compensatory aspects. Therefore, against the backdrop of the variability and complexity of the social environment, clarifying the explicit "excessively higher" standards, defining the clear nature of liquidated damages, and establishing a unified reduction scale are of great significance for the improvement of the discretionary reduction system in our country.

## **2. The Legitimacy Basis of the Discretionary Reduction System for Liquidated Damages**

### **2.1 The Embodiment of the Principle of Good Faith and Public Order and Good Customs**

The agreed liquidated damages are the product of the parties' autonomy of will, and state public power, including judicial power, does not need to intervene. However, autonomy of will should not be absolutized. When situations occur that damage public order and good customs, intervention and adjustment are needed [3]. Although the system of reducing liquidated damages and the remedy for gross unfairness stipulated in Article 151 of the Civil Code share similarities in avoiding unfair

outcomes, there are differences in their internal logic and mechanism of action: The system of discretionary reduction of liquidated damages focuses on the imbalance in the proportion between the objective amount of liquidated damages and the losses from breach of contract, and does not involve subjective factors such as the difficult state or cognitive ability of the parties at the time of contract formation. The core of the rule of gross unfairness lies in examining the remedies for procedural defects at the time of contract signing. The legal basis for the judicial reduction of liquidated damages is the two fundamental principles of public order and good morals and the principle of good faith, rather than the rule of gross unfairness. When excessively high liquidated damages become a means to suppress performance and abuse a dominant position, it clearly crosses the bottom line of social ethics, violates public order, good customs and good faith. At this point, the court needs to adopt a discretionary reduction system to prevent liquidated damages from becoming a tool for exploitation. The value basis for the reduction of liquidated damages lies in maintaining the concept of contract fairness reflected in the principles of public order and good morals and good faith - examining the bottom line of contract content with public order and good morals and constricting the exercise of rights with the principle of good faith [4]. It is precisely because of the synergistic effect of the principles of public order and good customs and good faith that courts can also have a basis to rely on when facing grossly unfair liquidated damages and uphold justice.

The principle of public order and good customs mainly takes effect from the stage of contract formation. It prohibits the parties from taking advantage of their dominant position or the other party's urgency or weakness to set a penalty far higher than a reasonable expectation, turning the contract terms into tools of exploitation. In such cases, even if there are clear written evidence, the court can deny its validity based on public order and good customs. The principle of good faith runs through the entire process of contract performance. After a breach of contract occurs, it restrains the non-breaching party from abusing their rights and prevents the non-breaching party from still claiming full liquidated damages when a minor breach occurs,

thus avoiding an imbalance in the fairness of the outcome caused by mechanically copying the breach of contract terms. However, although public order and good morals and the principle of good faith constitute the core basis for courts to intervene in liquidated damages, caution and restraint are still needed in their application in judicial practice. Only when the dual conditions of "the content of the contract seriously violates basic morality" and "the non-breaching party has abusive behavior" are met can the application of the principle of public order and good morals be triggered. Moreover, the principle of good faith can only be applied on the premise that "the claim of rights obviously exceeds a reasonable limit" and can be fully reasoned and demonstrated, so as to avoid escaping into abstract terms and thus nullating specific legal rules.

## 2.2 The Reconciliation of Contractual Freedom and Contractual Justice

The right to adjust liquidated damages, as a civil substantive right, is regulated by the principle of autonomy of will. However, excessive restrictions on autonomy of will or leaving it to its own discretion cannot appropriately balance the interests of the parties involved, resulting in the failure of the legislative intent to adjust liquidated damages [5]. For instance, in real transactions, it is possible that one party sets a penalty clause that is much higher than the actual loss, thereby generating an unequal punitive effect and eroding contractual justice. In this situation, the intervention of the system of reducing liquidated damages is a correction of the freedom of contract by the state's public power. While "excessively higher" serves as the standard for reducing liquidated damages and upholds substantive justice, it also reflects the concept of respecting the principle of autonomy of will. Therefore, the system of adjusting liquidated damages involves the coordination of the relationship between contractual freedom and contractual justice. Firstly, it aims to reconcile the interests of both parties, ensure contractual justice, balance the rights and obligations between the parties involved in the transaction, and ensure that the positioning of liquidated damages does not deviate from its main function. Second, starting from the principle of upholding contractual justice, it restricts the parties from making overly

arbitrary agreements, which may lead to the "gambling" situation of exorbitant liquidated damages. The rule of reducing liquidated damages has been widely recognized by all countries. Both the civil law system and the common law system generally hold that the agreement on liquidated damages lawfully arranged between the parties should be fully respected first, thereby fully protecting the autonomy of will and respecting the freedom of contract. Even if the liquidated damages agreed upon by the parties are inconsistent with the actual losses, it does not mean that the judge is granted the power to make arbitrary adjustments. In practice, the system of reducing liquidated damages must define the reasonable boundary of judicial intervention under the premise of contractual freedom. Only when the liquidated damages are seriously deviated from the actual losses and their functions are imbalanced can the court reasonably intervene. Otherwise, the mutual consent of the parties should be fully respected to establish clear application conditions and judgment standards. Neither should the penalty clause be allowed to be unrestricted, nor should the court's discretion become a source of uncertainty. Only in this way can the parties be urged to fulfill their obligations and keep their promises [1].

Article 5 and Article 7 of the Civil Code of the People's Republic of China stipulate that when engaging in civil activities, civil subjects should act in good faith and keep their promises in accordance with their own will, clearly adhering to the principles of autonomy of will and good faith. This is reflected in the application of liquidated damages by fully respecting the agreement between the parties regarding liquidated damages. The first paragraph of Article 585 is the general rule for the assumption of liquidated damages liability, while the second paragraph stipulates the adjustment of liquidated damages, setting "excessively higher" as the standard for the reduction of liquidated damages. Compared with the provisions of the first paragraph, it belongs to the nature of a but-for and is an exceptional situation for the assumption of liquidated damages liability. Based on this, some scholars in the academic circle believe that the second paragraph of Article 585 would grant judges overly broad discretionary power [6]. In fact, the second paragraph also imposes certain restrictions on the court's discretion:

Firstly, it must be based on the request of the parties. If the parties have not applied for the adjustment of the liquidated damages, the court has no right to make such adjustments. Secondly, only the liquidated damages that are "excessively higher than the losses caused" can be reduced at the discretion of the court. Liquidated damages within the reasonable range of contractual freedom do not require the court to intervene to maintain contractual justice. Thirdly, even if the two requirements mentioned above are met and the reduction procedure is initiated, the court can only make an "appropriate reduction", corresponding to the "excessively higher" standard, effectively coordinating the freedom of contract and contract justice. It is evident that compliance with the agreement on liquidated damages and the adjustment of liquidated damages are in a relationship of principle and exception. The liability for liquidated damages should mainly be non-adjustment, with adjustment as a supplement, to protect the autonomy of the parties' will, rather than being subjectively regulated by the judge.

### **3. Distinction and Application of Dual Functions of Liquidated Damages**

Article 585, Paragraph 1 of the Civil Code clearly stipulates that the liquidated damages shall be agreed upon in advance by both parties. If there is a breach of contract, the party concerned will bear the adverse consequences of paying the liquidated damages, which fully demonstrates the compensatory function of liquidated damages. Article 2 has been adjusted and optimized compared with the provisions of the Contract Law. The term "losses caused" has been expanded to include compensation losses in the predictability rule of Article 584 of the Civil Code, presenting the guarantee function of liquidated damages. As a result, the theoretical circle generally classifies liquidated damages into two categories: compensatory and punitive. The former is a penalty for breach of contract with the agreed content of damage compensation, which constitutes a penalty for breach of contract with compensation function. The core purpose is to make up for the losses caused by the breach of contract. The amount of the penalty for breach of contract is usually set in reference to the range of expected damage, and the proportion is reasonable. The latter takes urging performance as the agreed

content of the penalty for breach of contract, constituting a penalty for breach of contract with a guarantee function, aiming to punish and deter serious breach of contract, and the amount is generally higher than the expected loss range [7]. In practice, punitive liquidated damages usually occur in contracts involving public interests, moral obligations or core obligations, such as confidentiality agreements and non-compete agreements. Compensatory liquidated damages and punitive liquidated damages have significant differences in legislative basis, setting purpose and judicial handling logic. However, the Civil Code does not make a clear distinction in this regard, leading to disputes between the academic and practical circles over whether the judicial discretionary reduction rule for liquidated damages should apply to punitive liquidated damages or compensatory liquidated damages, and even resulting in the phenomenon of "different judgments in similar cases". Some scholars have pointed out that by setting "punitive liquidated damages" as the keyword through case library search and limiting the search scope to "court's opinion", a total of 6,826 judicial documents were found. From the perspective of first-instance judgments, 5,256 were fully or partially supported, accounting for 98.67%. All 55 cases were rejected, accounting for 1.03%. The other 15 items, accounting for 0.28%. From the perspective of the second-instance judgments, 911 cases upheld the original judgments, accounting for 69.17%. A total of 386 cases were overturned, accounting for 29.31%. The other 16 items, accounting for 1.21%. From the perspective of retrial judgments, 75 cases were overturned, accounting for 44.12%. A total of 48 applications for retrial were rejected, accounting for 28.24%. The original judgments were upheld in 42 cases, accounting for 24.71%. These phenomena of different judgments for the same case have seriously undermined the value and function of the punitive liquidated damages system [8].

Although punitive liquidated damages are often positioned as "grossly unfair", some scholars hold that the legal effect of punitive liquidated damages is that after the occurrence of a breach of contract, the debtor, in addition to paying the corresponding liquidated damages, should also fulfill the debt or bear the liability for damages arising from non-performance. The purpose is not to punish but to "exert as effective pressure

as possible. Thus, it ensures that the counterparty fulfills all the obligations it undertakes under the contract [9]. In fact, it serves the function of guaranteeing the performance of the debt. Therefore, the amount of liquidated damages can both compensate for the losses caused by the breach of contract and punish the breach of contract. At the same time, some courts hold that punitive liquidated damages are an agreement by the parties aimed at punishing the breach of contract by the breaching party. To prevent the occurrence of acts that violate good faith, it also reflects the attribute of autonomy of will. In contrast, there are also many scholars in the academic circle who oppose this view. Some scholars oppose the guarantee function of liquidated damages, arguing that civil law should mainly focus on compensation. They also believe that although liquidated damages have the function of urging the parties to fulfill the contract, this does not mean that all liquidated damages debts have a guarantee attribute. Only when the effectiveness of the debt is significantly enhanced, a reliable path is provided for the realization of the debt, and the characteristics of guaranteeing the realization of the creditor's rights are possessed, can it be regarded as having the attribute of guarantee [10].

In China, the principle of good faith is a fundamental principle that is more in line with the national conditions. Therefore, establishing a liquidated damages system with the guarantee function as the main and the compensation function as the secondary has unique significance. The cost of breach of contract being higher than the cost of performance not only enhances the performance guarantee, making debtors bear the excess compensation liability due to breach of contract, but also further plays a guarantee role in urging debtors to actively fulfill their obligations. At the same time, it can also make up for the corresponding breach of contract damage. Moreover, for the two parties who have not formed a trust relationship, agreeing on a relatively strict liability for liquidated damages is more beneficial for obtaining transaction credibility and encouraging transactions. Furthermore, since the purpose of the discretionary reduction system for liquidated damages is to safeguard the freedom of contract, the essence of compensatory liquidated damages is merely the pre-determined amount of damages. On the

basis of respecting the autonomy of the parties' will and not violating the principle of fairness, punitive liquidated damages can be regarded as true liquidated damages, functioning as a guarantee for performance, being a secondary obligation to the original performance obligation and the principal performance obligation. Unlike the compensatory liquidated damages as a predetermined amount of damages [11], while maintaining the stability of the contract, corresponding economic sanctions are imposed on the breaching party.

#### **4. Consideration of Comprehensive Factors for the Reduction of Liquidated Damages and Measurement of the Adjustment Scale**

For the system of adjusting liquidated damages, the principle of not reducing them reflects contractual freedom, while the exception of reducing them adheres to contractual justice. From a functional perspective, the provisions on liquidated damages in Article 585 of the Civil Code can be interpreted as having compensation functions and guarantee functions. In order to implement and promote the principle of good faith and the spirit of contract in the Civil Code, it is necessary to reflect on and reconstruct the exceptional reduction rules for punitive liquidated damages from the perspective of the balance between contractual freedom and contractual justice, with the guarantee function as the main and the compensation function as the secondary.

##### **4.1 Integration and Consideration of Comprehensive Factors**

When courts reduce liquidated damages, they mainly refer to the following factors: First is the actual loss, which is the most core and fundamental consideration factor. In practice, they often focus on reviewing the size of the gap between the agreed amount of liquidated damages and the actual losses suffered by the non-breaching party due to the breach of contract, including direct losses and some indirect losses. If the liquidated damages are significantly higher than the actual losses, it usually meets the main conditions for reduction. Secondly, there is the performance of the contract. When a breach of contract occurs, the proportion of the contract that has been performed, the stage of performance, and the extent to which the breaching part affects the realization of the contract's purpose will all

influence the judgment on the adjustment of liquidated damages. The court should not only distinguish between overall breach of contract and partial breach of contract, but also between fundamental breach of contract and non-fundamental breach of contract. When a contract stipulates a single amount of punitive liquidated damages for different degrees of breach of contract, the court may, based on the principle of fairness, not reduce them in the event of a major breach of contract, but reduce them in the event of a minor breach of contract [8]. The third factor is the degree of fault of the parties. Generally speaking, fault is not an element of the right to claim liquidated damages, but it is one of the evaluation factors for the comprehensive assessment of excessively high liquidated damages, and it is also conducive to the realization of the performance guarantee function of liquidated damages [12]. The more serious the subjective fault of the breaching party in the breach of contract, the greater the possibility that the court will oppose reducing or minimizing the adjustment of liquidated damages. In addition, if the non-breaching party is at fault, it is also an influencing factor for the reduction of punitive liquidated damages. Finally, there is the position of the parties to the contract. If one party (especially consumers, workers, etc.) is in a clearly disadvantaged position, such as as a consumer or worker, or there is a significant information asymmetry and other situations, the agreed excessively high penalty for breach of contract may be regarded as unfair or an abuse of a dominant position.

Although the above factors provide a relatively comprehensive reference for the court's discretion in practice and can reflect the practical model characteristics of the discretionary reduction system, which is "tailored to each case" and case-oriented, they also expose the defects of ambiguous standards and an unformed system. The most crucial issue is that the weight distribution standards among various considerations are not clear. For instance, does "actual loss" take precedence over "degree of fault"? How to choose when the two point to opposite conclusions? These issues will lead to an excessive discretionary space for judges and easily result in "different judgments for the same case". This will lead to the second problem: over-reliance on "actual losses". Some scholars hold that the issue of excessively high

liquidated damages is a legal problem rather than a factual one. Regarding the problem of excessively high liquidated damages, the measurement standard should not be limited to the comparison with actual losses [13]. In practice, there is indeed a tendency to overly emphasize "actual loss" as the basic standard for adjusting liquidated damages, and even to take it as the sole criterion. This seriously neglects the multiple functions of the liquidated damages system and lacks consideration of its dual functions, especially its core function of guaranteeing the performance of the contract, namely the guarantee function. Simply equating liquidated damages with estimated damages in this way would weaken the value of punitive liquidated damages.

In response to these issues, the factor system for adjusting liquidated damages should be restructured under the guidance of functionalism. For punitive liquidated damages centered on the guarantee function, the factors to be considered in their adjustment need to be distinguished from those of pure compensatory liquidated damages. More emphasis should be placed on the realization of the guarantee function. When making judgments, judges can take the subjective state of the breaching party as the main factor. Emphasis should be placed on examining whether the breach of contract is intentional or malicious. A malicious breach of contract is the key basis for the legitimacy of punitive liquidated damages and maintaining a relatively high amount. Secondly, taking "actual losses" as a reference, during the process of adjusting liquidated damages, it is necessary to prevent the role of punitive liquidated damages from being ignored.

#### **4.2 Measurement and Coordination of Adjustment Scales**

The most prominent condition regarding whether to initiate the adjustment procedure for liquidated damages is that "the liquidated damages are excessively higher than the losses". Article 65 of the Interpretation of the General Principles of the Contract Code stipulates that "if the agreed liquidated damages exceed 30% of the losses caused, the people's court generally may determine that they are excessively higher than the losses caused". This judgment standard is conducive to unifying the judgment criteria and reducing the difficulty of judgment. At the same time, there are also some

negative voices. Some hold the view that 30% should not be the upper limit of punitive liquidated damages and a higher standard should be set. Moreover, this judgment criterion is rather rigid and may easily overlook individual case differences as a result. However, for the judgment of "excessively high", its evaluation often has a certain degree of subjectivity. As an "irrational" factor in the application of the discretionary reduction system for liquidated damages [14], to ensure that the court's practical application is relatively uniform, if the liquidated damages exceed 30% of the agreed amount, it "generally can" be determined as "excessively high", and thus the adjustment procedure for liquidated damages can be initiated [7]. It is worth noting that not all cases must be determined in this way. This is not an absolute standard for adjustment. It can be flexibly and categorically applied in the special circumstances of individual cases. Therefore, although the 30% standard is not the best adjustment scale, having a standard is better than having none. Within the range of 30%, the deposit can be reduced at a smaller level compared to the penalty for breach of contract to respect the punitive nature of the deposit [15]. The specific adjustment scale needs to be analyzed on a case-by-case basis, and the parties should also be allowed to provide evidence to refute it.

## 5. Conclusion

The core value of the discretionary reduction system for liquidated damages lies in effectively reconciling contractual freedom with individual justice. While adhering to the foundation of autonomy of will, it also takes into account public order and good customs as well as the principles of good faith, preventing the liquidated damages clause from being distorted into a tool to oppress the breaching party. Based on this, respecting the fundamental principle that the parties have agreed that the liability for liquidated damages should be borne, the court's intervention in adjustment must be cautious and restrained, strictly following the initiation conditions and the restriction of "appropriate reduction", avoiding improper expansion of discretionary power, and ensuring that non-adjustment is the norm and discretionary reduction is the exceptional relief approach. The core of the inherent liquidated damages system lies in the

punitive liquidated damages with guarantee functions. Their value is not only in compensating for losses but also in effectively ensuring the performance of debts by setting breach consequences higher than the cost of performance. This is the key feature that distinguishes it from compensatory liquidated damages and is also the main application field of the judicial discretionary reduction rule. The key element for initiating adjustment, "the liquidated damages are excessively higher than the losses," should be based on the core spirit of Article 585, Paragraph 2 of the Civil Code, and a systematic and comprehensive assessment should be made from multiple dimensions such as actual losses, the degree of contract performance, and the fault of the parties. Even though Article 65 of the Interpretation of the General Principles of the Contract Code proposes "30%" as a reference standard, it is not an absolute rigid measure. In practice, it still needs to be flexibly grasped. The significance of this study lies in providing theoretical support and operational guidance for how to prudently apply the discretionary reduction rule in practice, achieve individual case justice while maintaining contract autonomy and transaction efficiency, and ultimately promote the unity of contract justice and transaction security. Of course, issues such as the concretization of judgment criteria and how to more precisely balance the guarantee function of punitive liquidated damages with the principle of fairness still need to be continuously explored in future theoretical deepening and judicial practice, with the aim of constantly improving the system of discretionary reduction of liquidated damages and making it better serve the fair and efficient market economic order.

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