

# The Penalty Clause: Theoretical and Practical Matters

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DOI: 10.6007/IJARBSS/v7-i5/2874 URL: <http://dx.doi.org/10.6007/IJARBSS/v7-i5/2874>

## **Abstract**

*Art. 1538 of the new Civil Code stipulates: "the penalty clause is the one by means of which the parties stipulate that the debtor undertakes a particular service in the event of non-fulfillment of the principal obligation" (paragraph 1). According to paragraph 2 of the same article, in the event of non-execution, the creditor may request either the enforced execution in kind of the principal obligation or the penalty clause. Moreover, the creditor may request the enforcement of the penalty clause without having to prove the existence or the amount of the damage. The penalty clause finds its applicability in the performance of obligations, more precisely in the case of execution by equivalent." The amount of the penalty clause is determined in advance, based on assessment. The advantage for the creditors consists in the fact that they no longer have to prove the existence and the amount of the damage if the debtor fails to perform their obligations according to the contractual provisions. The penalty clause is not meant, but must be expressly provided. The validity of the penalty clause depends on the validity of the agreement which stipulates it, since the nullity of the penalty clause does not entail the nullity of the principal clause.*

**Key-Words:** Contractual obligation, non-fulfillment, penalty clause, amount, default

## **1. Introduction. Theoretical concepts**

### **1.1. Concept**

The penalty clause may be defined as the contractual provision by means of which the parties jointly determine the amount of compensation to be owed by the party who has wrongly failed or has properly fulfilled their contractual obligations. In other words, the penalty clause is a contractual stipulation by means of which the parties assess the contractual damages in advance. The amount of the penalty clause is determined in advance, based on assessment. The advantage for the creditors consists in the fact that they no longer have to prove the existence and the amount of the damage if the debtor fails to perform their obligations according to the contractual provisions.

The penalty clause is not meant, but must be expressly provided (Terzea, 2014).

### **1.2. The governing law**

The penalty clause is governed by art 1538-1543 of the new Civil Code, but it is also referred to and stipulated in other articles, such as art 1757 (2), which stipulates in terms of contract termination that "when it has been decided that the amounts cashed as installments will wholly or partially remain with the seller, the court will be, however, able to reduce these

amounts, based on the provisions regarding the reduction of the penalty clause's amount by the court". Moreover, the penalty clause is indirectly approached in art 1535 and 1536 of the Civil Code, which provide the conventional determination of the damages, which is, in fact, a penalty clause. As per art 1538 (1) of the Civil Code, "the penalty clause is when the parties stipulate that the debtor undertakes a certain service in the event of the non-execution of the principal obligation" (art 1538 (1) of the new Civil Code).

### **1.3. The object of the penalty clause**

Following the analysis of the aforementioned law, it follows that the early assessment should not necessarily be a monetary benefit (payment of an amount of money). The penalty clause may have as object an obligation to give (another good than the one owed or a quantity of similar goods, etc.) or an obligation to do something (to render a certain service as an equivalent). An atypical case of penalty clause is also the one stipulated in art. 1538 (5) of the new Civil Code, which stipulates the right of the creditor to withhold the amounts cashed until that time, in case the debtor fails to fulfill the obligations.

The provision of the penalty clause in the contract is of practical use because it avoids the difficulties of assessing the damages, since the creditor is not compelled to prove the determined under in the penalty clause, it is sufficient for the creditor to prove the non-execution, improper or late fulfillment of the obligation undertaken by the debtor.

### **1.4. The ancillary nature of the penalty clause**

The penalty clause has an ancillary nature, which means that the validity of this clause depends on the validity of the agreement which stipulates it, according to the principle *accessorium sequitur principale* (Terzea, 2014). Thus, art 1540 (1) of the Civil Code states that the nullity of the penalty clause does not entail the nullity of the principal obligation, but the nullity of the principal obligation also entails that of the penalty clause.

### **1.5. The creditor's right of option**

Art 1538 (2) of the Civil Code provides for the right of the creditor to make an option in the event of the debtor's failure to perform the obligation, for the enforced execution in kind of the principal obligation and the execution of the penalty clause (i.e. the receipt of the predetermined monetary or whatever equivalent) (Boroi and Stănculescu, 2012).

However, it should be noted that the right of option does not exist unless the non-execution is the fault of the debtor, referring to the conditions of contractual civil liability. This conclusion arises from the construal of the provisions under art 1540 (2) of the Civil Code, according to which "the penalty cannot be demanded when the execution of the obligation has become impossible due to causes non-imputable to the debtor". Therefore, in cases where the non-fulfillment of the obligation arises as a result of a case of force majeure or a fortuitous case and is not imputable to the debtor, the penalty clause cannot be applied.

### **1.6. The Operation of the Penalty Clause**

The penalty clause becomes chargeable only if the conditions of the debtor's contractual liability are cumulatively met. Given that the service determined under the penalty clause is fixed, according to art 1541 (1) of the Civil Code, in principle, the court cannot change in any way the amount of the penalty clause. This provision is an application of the principle of the binding force of the contract.

However, by way of exception, the penalty clause may be amended by the court when:

- The principal obligation has been partially enforced and this execution has been beneficial for the creditor (art 1541 (2) (a) of the Civil Code).

- The penalty is manifestly excessive in relation to the damage that could have been foreseen by the parties upon the conclusion of the contract (art 1541 (2) (b) of the Civil Code), in which case the court may order the reduction of the amount of the service.

The Court of instance may apply the reduction of the penalty when it is excessive, but not under any circumstances (Oglindă, 2012).

We also point out that, by reference to art 1539 of the Civil Code, when the penalty clause has been stipulated for the non-execution of the obligations, it cannot be cumulated with their execution in kind nor with any compensatory damages.

On the contrary, when the penalty clause has been stipulated for inappropriate execution, the penalty clause can be cumulated with the remedy of enforced execution in kind.

In the case of the indivisible but non-compulsive principal obligation, if the non-execution arises from the action of one of the debtors, the creditor is entitled either to claim the entire penalty from the party guilty of non-execution or to demand partial payment of the penalty from each indivisible debtor, but only for their part. In the latter case, the co-debtor who paid has the right of recourse against the one "who caused the non-execution".

If the principal obligation is divisible, then the penalty is also divisible and will be borne only by the co-debtor guilty of non-execution and only for the part in their charge.

In conclusion, we point out that the legal regime of the penalty clause is characterized by the following features:

- The presumption of the existence of the damage has been expressly regulated, the creditor being able to request the execution of the penalty clause without being required to prove the existence of any prejudice;

- The court has the right to reduce the amount of the penalty if it is manifestly excessive in relation to the foreseeable prejudice caused to the creditor;

- The penalty cannot be demanded when the execution of the obligation has become impossible for reasons not imputable to the debtor.

## **2. Practical Matters**

The plaintiff, SC BR SRL, sued the defendant SC RP SRL, asking the court to compel the defendant to pay the amount of 273,495.90 lei, as the equivalent of the amount of 79,500 US dollars, as compensation for the damage incurred following the non-execution by the defendant of their contractual obligations and the payment of the related interest from the date of the legal claim and until the payment of the debt, including court fees.

In order to substantiate the claim, the plaintiff stated that on June 11, 2012 they concluded with the defendant the sale-purchase contract for sunflower seeds, whereby they undertook to sell a quantity of 500 tons of sunflower seeds, of Romanian origin, in bulk, from the 2012 harvest at the price of USD 500/ton, which did not include VAT.

The plaintiff stated that the merchandise had to be delivered between 10.08.2012 - 30.09.2012, but on the due date the defendant culpably did not deliver the merchandise which was the subject of the contract, although the parties did not foresee the possibility that the defendant could unilaterally terminate the concluded agreement.

Since the party is a producer of sunflower oil and has the obligation to comply with other orders, the plaintiff asserted that they had to buy sunflower from other suppliers, at a price of USD 677/ton, so that the damage suffered is the price difference for each ton of sunflower which they had to pay in addition to its purchase in September 2012.

The plaintiff also pointed out that, as a creditor, they were entitled to the debtor's fulfillment of obligations, the unlawful act of the defendant consisting of the fact that it had not fully complied with the obligation to deliver the quantity of 500 tons of sunflower seeds, and thus the latter had to acquire similar merchandise at a higher price in order to be able to fulfill their obligations to third parties.

Based on documentary evidence, by sentence no. 4179/11.12.2013, the Tribunal of Buzau allowed the action, ordered the defendant to pay to the plaintiff the amount of 79,500 USD in the equivalent in lei from the date of the petition, with related interest from the date of the claim and up to date of actual payment and 21,097.43 lei as court fees.

In order to rule this judgment, the court of first instance noted that, given that the defendant had not delivered the quantity of sunflower seeds contracted, the plaintiff purchased a quantity of 1200 metric tons of the same product from SC BTR SRL at the price of 677 USD/ton, considering that there was a loss of USD 79,500 representing the additional price difference paid for the merchandise that should have been delivered by the defendant.

The court of first instance found that the contract in question was valid, resulting in legal consequences for the parties, with their obligation to fulfill their mutual contractual obligations, namely the defendant to deliver the quantity of 500 metric tons of sunflower seeds with characteristics stipulated in the contract, and the plaintiff to pay the value of the products delivered.

The fact that the defendant failed to fulfill the obligation to deliver the merchandise led the plaintiff to acquire merchandise of the same nature from another company, but at a higher price than that provided for in the contract with the defendant, leading to a loss in amount of 79,500 USD, consisting of the price difference for the quantity of sunflower purchased.

Thus, all the cumulative conditions for entailing the contractual civil liability are met, namely the existence of material damage caused to the plaintiff, a breach of the contractual obligation consisting in the total non-performance of the defendant's obligation to deliver the merchandise and the fault of the defendant in non-performance of the obligation; and the causal link between the non-fulfillment of the obligation and the damage suffered by the plaintiff.

The court also noted that the parties' contract had been validly concluded, that the defendant had failed to fulfill the contractual obligations and that, consequently, the plaintiff had suffered a certain damage as a result of the difference in price paid to purchase the same quantity of sunflower, and taking into account the provisions of art 1350 and 1516 of the Civil Code, the court allowed the action (Buzău County Court of Law, 2013).

The defendant SC RP SRL appealed against this decision, requesting its admissibility and rejecting the plaintiff's action as groundless because the damage suffered by the said did not exist and had not been proven.

However, the determination of the damage, as part of contractual liability, must comply with the provisions of art 1350 of the new Civil Code, which states that non-execution must be unjustified, which is not the case here.

Moreover, the plaintiff did not state the reasons for which, following the legal claim, filed documents stating that they had to buy a larger quantity - 1,200 tons of sunflower seeds from SC BTR.

Similarly, the court of first instance did not show the reasons why it dismissed all the defense filed by the defendant on the merits, and instead the civil ruling subject to the appeal obviously omitted to analyze and decide in any way on the discussion on the valid conclusion of the contract, of the obligations undertaken by it, of the reality of the damage suffered, rejecting the evidence requested in the defense, without giving the reasons for the rejection of the administration of the requested evidence.

The court of first instance noted that, in respect to the debtor's default regarding a contractual obligation, that it is presumed by the mere fact of non-enforcement, in accordance to art 1548 of the Civil Code.

The unlawful act of the defendant consisted in the complete non-fulfillment of the obligation to deliver 500 metric tons of sunflower seeds on the agreed deadline, as it was bound by the contract.

The Court of Appeal, as a court of judicial control and analyzing the documents and the papers of the file, the legal provisions in the matter, as well as the provisions of art 176-179 of the new Code of Civil Procedure, allowed the appeal for the following reasons:

In the contract concluded, the parties provided that "if the seller does not deliver the entire merchandise within the contractual delivery period, the buyer has the following rights to their discretion: the buyer has the right, starting from the first day after the expiry of the delivery deadline, to buy the entire quantity of the non-delivered merchandise from third-party vendors at the sole discretion of the buyer. In this case the seller will undertake, upon the written request of the buyer, to indemnify them with the amount representing the difference between the price paid for the purchase of the quantity of the non-delivered goods from third parties and the price established by this contract. If the seller does not pay this compensation within 15 days from the receipt of the buyer's written request, the latter will be able to request the calculation and payment of 0.1% delay penalties. The penalties shall be calculated to the outstanding amount and up to full payment thereof. At the buyer's decision, the seller will pay the buyer a penalty of 0.1% per day of delay calculated at the value of the undelivered

merchandise. The penalty shall be calculated from the first day after the expiry of the delivery period until the delivery of the total quantity of the contracted merchandise."

Also, in the same contract, the parties provided that "in order to secure the fulfillment of the obligation to deliver on time the entire amount contracted, the seller will issue a promissory note amounting to 30% of the value of this contract, endorsed in their own name by the vendor's representative, due in 15 days after the last day of the delivery period agreed upon in the article about the terms of delivery which will be returned to the seller within 10 working days at the most from the full execution of the contract. If the seller does not fully meet their obligation to deliver on time, the buyer is entitled to collect the promissory note. If the promissory note is not in the possession of the buyer within 24 hours from the contract being issued, the contract shall be deemed canceled and shall not give rise to any commercial or legal effects." Also, the delivery term of the merchandise was stipulated in the contract as the period 10.08.2012-30.09.2012.

In this case, it was requested for the defendant to be ordered to pay the sum of 75,500 USD in lei equivalent as damages representing the amount of the damage suffered by the plaintiff as a result of the culpable non-performance of the contractual obligations undertaken by the defendant, compelling the defendant to pay the interest calculated from the date of the petition to the date of actual payment.

The Court of Appeal, by analyzing and interpreting the penal clause stipulated by the parties in the sale-purchase contract, finds its ineffectiveness because it did not stipulate a certain amount of compensation (the difference between the price paid for the purchase of the quantity of non-delivered merchandise from third parties and the price established in the contract). Thus, according to art 1538 (I) of the Civil Code, the criminal clause is the one by means of which the parties stipulate that the debtor is bound to a certain service in the event of non-fulfillment of the principal obligation. Therefore, since the service had not been determined according to the law, the criminal clause could not be enforced. On the other hand, with regard to the damage, according to art 1537 of the Civil Code, the proof of the non-performance of the obligation does not exempt the creditor from the proof of the damage, unless otherwise provided by law or by the contract between the parties. In this case, given that the plaintiff bought 1200 tons of sunflower seeds at the price of 2374.85 lei on 27.09.2012 from SC BTR SRL, does not prove that these tons were for the replacement of the 500 tons contracted by the defendant.

### **3. Conclusions**

Therefore, the Court concluded that, as regards the aforementioned factual situation and as per the provisions of the Civil Code (art 1350 of the Civil Code on contractual liability, art 1516 et seq. on enforced execution of obligations, as well as art 1650 et seq. on sale-purchase contracts), the grounds of appeal are substantiated, the appealed ruling being ungrounded as regards the merits of the case. This is because, as stated above, the mere non-performance of the contract cannot result in the seller being ordered to pay damages (Ploiești Court of Appeal, 2014).

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