

The Role of the Penalty Clause in Business

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Abstract

The interest in this topic is determined, on one hand, by the way of interpreting the provisions which regulate the contractual liability in general and of those regarding the penalty clause in particular, and, on the other hand, by the formulation of certain proposals *de lege ferenda*. By stipulating the penalty clause, the law seeks to execute the contractual obligations, and not to collect penalties. The legal base of the ancillary character of the penalty clause is article 1538, paragraph 3 of the Civil Code.

Keywords: contract, business, clause, obligation.

1. Introduction

When concluding a contract, the parties consider the liability for not meeting the contractual obligation. Most commonly, especially in contracts on commercial activity, the parties stipulate a penalty clause as a way of enforcement of the contractual obligations. It is resorted to the penalty clause, for it involves the parties' agreement on the liability for non-compliance with the obligations, materialized into an amount of money, and the right to indemnities for the damage is easier to capitalize on than the right to damages-interests, according to the conditions of the Civil Code (Cărpenu, 1981). In the Civil Code, the penalty clause is used by the parties to stipulate that the debtor is obliged to follow certain rules in case of non-complying with the main obligation (article 1538 of the Civil Code).¹ There must be noticed that, usually, through the penalty clause the parties agree and stipulate in the contract the amount of money that the debtor undertakes to pay to the creditor for non-complying with the obligation, that is for not meeting the obligation or the inadequate or delayed performance of the obligation. The amount of money is named penalty. Therefore, the penalty clause is a convention through which the debtor undertakes to pay to the creditor an amount of money called penalty, in case he fails to perform the contractual obligation according to the conditions.

2. The characteristics of the penalty clause

From the definition result the following characteristics:

a. The penalty clause is a convention between the parties.

In order for the obligation of paying penalties to exist there must be a will agreement of the parties through which there must be established the deviation (non-performance, delayed performance that leads to penalties, as well as the amount of the penalties).

b. The penalty clause must be in written form.

In order for the liability as penalty to exist, the penalty clause must exist in the contract that has to be concluded in written form. Therefore, in case of this kind of liability it is not enough for any kind of contract to exist (*negotium juris*), but there must be a contract concluded in written form (*instrumentum*), in which the penalty clause has to be stipulated. In the contrary case there can only be engaged the liability as damages-interests.

¹ The provisions of the Civil Code regarding the penalty clause are also applicable to the convention through which the creditor is entitled to keep the partial payment made by the debtor in case of the contract termination caused by the debtor (article 1538, paragraph 5 of the Civil Code)

c. The penalty clause is an ancillary convention.

The convention regarding the penalty clause not have autonomy, but it depends on the existence and validity of the main obligation. The main obligation's nullity draws the nullity of the penalty clause, but the nullity of the latter does not affect the validity of the main obligation (article 1540 of the Civil Code).

d. The penalty clause has as object the payment of a penalty

According to the Civil Code, through the penalty clause, the debtor is obliged to a certain performance in case he does not perform the main obligation. This performance represents the penalty and it usually consists of an amount of money contractually or procentually established.

3. The penalty clause and the performance of the obligation

The Civil Code covers certain provisions concerning the relation between the penalty clause and the performance of the obligation. The penalty clause obliges the debtor to pay an amount of money (the penalty) for not performing the contractual obligation. The penalty can be, depending on the case, for the non-performance (in nature) of the obligation or for the improper performance or delayed performance.

According to the law, in case of non-performance (in nature) of the main obligation, the creditor may ask either for forced execution in nature, or for the penalty clause, if there is one (article 1538, paragraph 2 of the Civil Code). Since the penalty has been stipulated in the contract in order to be applied in case of non-performance, the creditor cannot add the penalty clause to the performance in nature of the obligation (Article 1539 of the Civil Code). If the debtor performed (in nature) the obligation, but with delay and improperly, the creditor would be able to add the performance in nature of the obligation to the penalties for delay, if the latter have been stipulated in the contract. In this case the creditor can settle for the performance of the obligation, being able to accept with no reservations the performance of the obligation and to give up on the penalties (article 1539 of the Civil Code). There must be pointed out that, since the penalties which constitute the object of the penalty clause do not represent a replacement of the performance of the contractual obligation, the debtor cannot get rid of his obligation by offering the creditor the amount of money they have agreed on (article 1538, paragraph 3 of the Civil Code).

4. The functions of the penalty clause

a. The sanctioning function.

The non-performance of the obligation taken by contract constitutes a breaking of the contract, but also a breaking of the law. The penalty clause has the role to stimulate the parties to respect the contractual obligations, and when the deviation is produced it has the role to sanction the illicit act, namely the non-performance of the contractual obligation.

b. The reparatory function.

The debtor's failure to comply with the obligation can cause certain damages in the creditor's patrimony. The stipulation of the penalty clause ensures the indemnity by shifting the negative effects in the debtor's patrimony. The effectiveness of the reparatory function of the penalty clause depends somewhat on the amount of the penalties.

c. The evaluating function.

By stipulating the penalty clause, the parties agree on the amount of money the creditor will have access to if the debtor fails to comply with the undertaken obligation. So, the penalty clause also meets an anticipated evaluating function of the damages-interests that the debtor shall pay in case of not performing the obligation the penalty was created for.

d. The guarantee function.

The penalty clause also has the role of a guarantee. By stipulating a penalty clause, the creditor has a guarantee that the debtor will perform his obligations, for, in the contrary case, he will be obliged to pay the agreed penalty.

5. The conditions that need to be met in order to give penalties.

In order to claim the penalties stipulated in the contract for the debtor's non-performance of the obligation there must be met certain conditions. These conditions are, in principle, those required for the liability under the form of damages-interests, but with certain particularities.

a. The existence of a contract concluded in written form, in which the penalty clause be stipulated. In the absence of an agreement between the parties regarding the deviation and the amount of the penalty stipulated in written form, there is no liability under the form of penalties.

b. The non-performance or the improper or delayed performance of the obligation. The debtor is obliged to pay the agreed penalty only if he committed the deviation that the penalty clause has been stipulated for. In case of delayed performance, the debtor owes the delayed penalties from the due date until the performance of the obligation.

c. The damage. If in the contract has been stipulated a penalty clause for a certain deviation, in case of committing that deviation the creditor has the right to access the penalty due to him without being obliged to present any proof of the damage (article 1538, paragraph

d. The reason of the law's solution lies in the fact that paying the penalty is the effect of the convention made between the parties. It may be considered that, by stipulating the penalty clause, the parties had in mind producing a damage as a result of failing to comply with the obligation, and, with their agreement, they have evaluated in advance the amount of money that the debtor must pay to the creditor for covering the damage (Turcu, 2009, p.123). Considering this role of the penalty clause, the debtor is not entitled to prove that by not complying with the obligation the creditor has not suffered any damage or that the suffered damage is lower than the amount of the penalty. Justifying the solution also lies in the fact that, as previously mentioned, the penalty clause has, besides the reparatory function, the sanctioning function.

e. The causal link between the non-performance of the obligation and the damage. This condition lacks importance since the payment of the penalty is agreed on by the parties whether it causes any damage or not.

f. The debtor's culpability. Since the penalty clause has a sanctioning function, its applicability is only justified if the non-performance of the obligation is imputed to the debtor (article 1547 of the Civil Code). In this sense, article 1540, paragraph 2 of the Civil Code specifically states that the penalty cannot be demanded when the performance of the obligation has become impossible due to causes imputable to the debtor. Because the penalty clause represents a form of the contractual civil responsibility, the culpability of the debtor is presumed due to the mere non-performance of the obligation (article 154, paragraph 2 of the Civil Code).

g. The debtor's delay. In order to give penalties, which is the object of the penalty clause, the debtor must be delayed according to the conditions of the law (article 1516, paragraph 2 of the Civil Code). Regarding the obligations resulted from the contracts on commercial activity, delaying is not necessary for the debtor is entitled to delay if he has not preformed the obligation of paying an amount of money undertaken in the activity of a company.

6. Reducing the amount of the penalty.

The debtor's failure to comply with the obligation that the contract provides a penalty clause for gives the creditor the right to access the amount of money that constitutes the penalty, if it is all according to the law. The penalty clause, as a contract, has legal force and determines compulsory effects both between the parties and on the court (article 1270 of the Civil Code) (Turcu, 2009, p. 523).

In light of the compulsory force of the contract, the creditor is entitled to access the stipulated penalty which cannot be either removed or reduced by the court.

The New Civil Code has specifically consecrated the applicability of the principle of the compulsory force of the penalty clause, but for certain reasons it exceptionally allows two cases in which the court can reduce the penalty (article 1541 of the Civil Code). The penalty can be reduced if the main obligation has been partially performed and this performance has benefited the creditor.

Reducing the amount of the penalty in the case of a partial performance of the obligation, which is also admitted by the old Civil Code, is legit. Since the penalty also concerned the utter non-performance of the obligation, if the obligation is partially performed its applicability is only imposed in relation with the rest of the obligation that has not been executed.

The penalty can be reduced if its amount is clearly too big in relation with the damage that could have been stipulated when concluding the contract. The legal regulation of the court's right to reduce the excessive penalties answers to a need that was common in the old practice of the courts of law which, lacking a legal regulation, have resorted different solutions.

Beginning from the principle according to which only the legal agreement has legal force between the parties and on the court of law, the judicial practice has decided that an abusive penalty clause, which is a penalty clause which has as object a penalty whose amount is excessive, can be reduced by the court of law. Considering the excessive character of the penalty, the court must take into account the conditions under which the parties have concluded the agreement and the possibility of establishing the amount of a possible damage caused by not complying with the obligation (Tutuianu, 2008).

Because reducing the penalty might diminish the effectiveness of the penalty clause as legal way to ensure the performance of contractual obligations, the law establishes a limit of the cutback; the reduced penalty must remain bigger than the main obligation (article 541, paragraph 2 of the Civil Code), for the same purpose the law says that any contrary stipulation is considered unwritten.

With respect to the cutback of the penalty, in literature have been expressed opinions that approach this topic both from the point of view of the current regulation and from the point of view of the old Civil Code. Thus, it has been stated that the law allows the parties to establish and agree upon the amount of the indemnities for the culpable non-performance of the obligations. This was achieved a conventional evaluation through a stipulation named penalty clause.

The purpose of the penalty clause is to remove the difficulties of the appreciation in court of the amount of the damages-interests, considering the fact that the evaluation of the damage in the moment it is produced can be expensive and complicated.

In the New Civil Code the legal basis of the penalty clause is constituted by article 1.538, paragraph 1, which stipulates that "the penalty clause is that in which the parties stipulate that the debtor is obliged to respect certain conditions in case he fails to comply with the main obligation".

In principle, the New Civil Code does not change the juridical regime of the penalty clause in relation with the old regulation, but merely coherently systematizes the regulations regarding this institution. Nevertheless, there are some notable changes, one of them concerning the court's possibility of reducing the penalty clause in case it is obviously excessive in amount.

According to the previous regulation regarding the constant juridical practice, the court could not reduce the amount of the penalty clause. According to article 1087 of the old Civil Code, "when the convention involves that the party which will not perform the obligation will pay a certain amount of money as damages-interests, the other party cannot receive a bigger or a smaller amount." The only exception is in the case of a partial performance of the obligation, with the amendment that the court will have the possibility, but not the obligation to reduce the penalty, for according to article 1070 of the old Civil Code, "the penalty can be reduced by the judge (...)". The stipulations of this article used to be interpreted in relation to article 1.101 of the old Civil Code, and according to them, the validity of the partial payments depended on whether the creditor accepted them or not. Therefore, article 1070 is only applicable when the creditor accepts the partial payment from the debtor, or when such a payment is allowed by the contract (Angheni, 2013).

Thus, the amount of the damages-interests established through the penalty clause used to be, according to article 1087 of the old Civil Code, permanent, the legal intangibility of the penalty clause being clearly and imperatively posited. We obviously consider the situation in which a penalty clause has been stipulated, without existing another contractual provision through which the parties could have stipulated the possibility to limit the penalties.

In literature has been considered that the solution in the Civil Code of 1864 was left behind compared to the one we find in other law systems such as the Italian or Swiss one, which give the judge the possibility to interfere when needed in order to change the amount of the penalty clause by increasing or decreasing it. Likewise proceeded the French legislator with respect to the provision in article 1152 of the French Civil Code which stipulates that, in principle, the amount agreed by the parties as a penalty clause can be neither increased, nor decreased, by adding to it a new paragraph according to which the judge can – even on his own – even moderate or increase the penalty if it is obviously excessive or derisory. Therefore, in France, the principle of interference of the judge with respect to the possibility of changing the penalty clause is seen as belonging to the public order, the parties being unable to remove through their convention this power that has been legally given to him.

In the classic doctrine has been appreciated that the solution in the legislations of other states regarding the judge's possibility to interfere, although equitable, breaks the very purpose the penalty clause has been established for, that is removing the call on justice to fix the damages. If it had been admitted that the court be able to reduce the penalty clause, it would have failed to fulfil its essential role – of compelling the parties to perform the obligation – for it would have no longer represented a threat for the debtor. It would have been of no use, for, independently on the amount of the penalty clause, in case of non-performance the debtor would have only been obliged to cover the worth of the damage with the amount that he would have owed anyway, if the penalty clause had not existed.

Article 1538 stipulates the rule according to which in case of non-performance, the debtor owes the penalty stipulated in the contract. There are two exceptions from this rule: 1. to reduce the penalty when the main obligation has been partially performed, and it benefited the creditor; 2. to reduce the penalty when it is excessive in amount and the court notices that the penalty is much different in amount than the anticipated damage (Tutuianu, 2013).

We point out that both exceptions depend on the court which is obliged to reduce the penalties whenever needed. The first exception represents a repetition of article 1070 which is supported by article 1.101 of the old Civil Code.

With respect to the second exception from the this rule, article 1.541, paragraph 1 .b) of the New Civil Code stipulates that “the court can exceptionally reduce the penalty when it is much different in amount than the anticipated damage”, and paragraph 2 stipulates that “the penalty reduced this way must, nevertheless, remain superior to the main obligation.” The legislator has seen in the penalty clause a strong punitive character which will dominate the reparatory character in the new regulation.

The new provisions will generate discussions and non-unitary legal practice, since the legislator has not defined the word “excessive”, which means that it remains the court’s duty to determine this. In a solution given before the implementation of the New Civil Code, it was considered that a penalty clause of a commercial delay of 6% a day does not constitute the excessive penalty clause, while the courts of law have considered that the value of delay of 1% a day exceeds the level of the common reasonable penalties stipulated in various legal provisions.

In the literature prior to the New Civil Code it has been asserted that the damage cannot be exceeded with more than 25-30% in the civil contracts and 30-40% in the contracts in which the lucrative character is strong and clear (those between professionals). Or, anyway, the penalty clause should be reasonably reduced, for example at the double of the value of the damage.

The New Civil Code stipulates that the penalty must be considered very disproportionate in relation to the damage that the parties could have predicted when concluding the contract, without taking into account the actual damage.

On the contrary, in the French legal practice has been chosen this very last criterion. The French courts of law consider, at the same time, the penalties regularly stipulated in the same type of contracts, as well as the cause of the obligation with the penalty clause. Thus, we can notice that in the French regulation the analysis of the penalty clause regarding its excess of amount reminds us of the legal evaluation, which points out a genuine reparatory character.

The regulation from the New Civil Code does not take into consideration the actual damage. The legislator’s reason of underlying the dominating punitive character of the penalty, without obliging the creditor to make the proof of a thing that both parties wanted to remove: the proof of the damage, as it happens in the French legislation. Besides, article 1538, paragraph 4 stipulates that the creditor can ask the performance of the penalty clause without having to prove any damage.

Depending on the circumstances, the contractual parties can admit or not their weaknesses on the market. The non-performance of the obligation by one of the parties can sometimes lead to the insolvency of the other, which produces chain damage. This way the creditor might want to make sure of the co-contractor’s good faith with respect to the payment, and a heavy penalty can determine the debtor to perform his obligation. Thus, the same penalty can be equitable in a contract, based on some subjective matters exclusively deriving from the relations between the parties, or the penalty can present an excess of amount in another contract.

The legislator did not establish limiting criteria, but a general criterion: the damage that the parties could have predicted when concluding the contract. Along with this criterion according to which it is established whether the penalty clause is excessive or not, there also exists the imperious condition of an obvious disparity between the two elements compared by the court of law: the predictable damage and the penalty.

From the provision according to which “the court cannot reduce the penalty” (article 1538 paragraph 1 of the New Civil Code) we might be tempted, by resorting to an interpretation *per a contrario*, to conclude that it can be increased, the court being able to give bigger indemnities than the stipulated ones. Actually, unlike the French legislator’s intervention according to which it is a fully possible to increase the amount of a derisory penalty clause, the Romanian legislator has chosen only the possibility of reducing it by making exception from article 1538 of the New Civil Code.

Thus, talking about exceptional norms, they will be restrictively interpreted in compliance with the principle *exceptio est strictissimae interpretationis et applicationis*. To apply this rule we no longer need to resort to the tradition of the Romanian Law, but to the norms of the positive law. According to article 10 of the New Civil Code, “the laws that derogate from a general provision, those which restrict exercising certain civil rights, or those which stipulate civil sanctions, are applied only in express cases and are restrictively stipulated by the law” (Filip et al., 2007).

In the literature prior to the implementation of the New Civil Code have been generally called up proposals *de lege ferenda* in order to increase the amount of the penalty clause when it is insufficient, as well as it can be decreased when excessive. For the already mentioned reasons, we appreciate that they have not taken shape within the new regulation.

Also, if in the French legislation was explicitly stipulated that the judge can interfere “on his own”, the Romanian Civil Code did not adopt this. Anyway, we believe that the court of law can take action on its own with respect to the obvious disproportion of the penalty, and reduce it. The court’s intervention derives from a systematic interpretation of the norms that regulate the penalty clause. If in article 1.538 the law refers to the conduct of the parties, “the creditor can ask...”, “the debtor cannot free himself from...”, “the creditor is entitled to...”, which suggests the parties’ availability, in article 1.541 the legislator stipulates that “the court cannot reduce the penalty unless...”, which suggests exactly the active role, that is the possibility to censor on its own the excessive penalty. The legislator ignores the debtor’s request, so he ignores the principle of availability, and includes the court’s intervention in the power of the active role.

Beyond a systematic interpretation, the provision of article 1.541, paragraph 3, which stipulates that “any contrary stipulation is considered unwritten”, denotes the imperative character of public order of the norms which regulate the reduction of the penalty clause. Therefore, the exceptional character of the reduction of the penalty clause does not only reflect hues of substantive law, but also of procedural law. When the parties have turned a limiting clause of liability into a penalty clause, settling derisory limit of the damages-interests, the penalty clause can be cancelled to the extent to which it illicitly limits the contractual liability such as, for example, in case of a non-performance caused by intention or heavy culpability. Besides, the New Civil Code clearly stipulates that the liability for the material damage caused to the other party through an intended act or heavy culpability cannot be excluded or limited by conventions or unilateral acts (article 1.355, paragraph 1). The disguised penalty clause being null, the creditor will be able to cover the prejudice by resorting to the legal evaluation.

According to article 6, paragraph 2, the New Civil Code of Law no. 71/2011, “the acts and legal facts concluded, committed or produced before the implementation of the new law cannot generate other juridical effects other than those stipulated by the law in force at the date of concluding, committing or producing them.” In the same row of ideas, article 15 of the law of applicability stipulates: “the penalty clause agreed on after the implementation of the Civil Code generates the expected effects independently on the date of birth of the main obligation.”

In the state of the art has been generally shown that in many frequent cases the New Civil Code solves a controversial problem, offering one of the solutions given in jurisprudence or in the doctrine corresponding to the previous regulation. In such a case, even for the previous situations the solution which the new regulation stopped at could be given (and it is even recommended to consider the imperative of having a predictable legal practice), without claiming that a retroactive effect is given to the new law, but the solution cannot be based on the provisions of the new law, but it can be motivated by the reasons derived from the old regulation (Filip, 2005; Tutuianu, 2008).

The suggestion is built on a good reason and in full compliance with the imperative given by the jurisprudence of the European Court of Human Rights that asks the states to establish predictable and accessible legal norms. Reducing the penalty clause represented more of a doctrinaire problem for the old regulation, for the legal practice was unanimous in refusing its reduction without having a good reason, an exception being the situation stipulated by article 1070 of the old code. For this reason and starting from the transitory provisions regarding the applicability of the law in time, it can be said that, in case of a penalty clause stipulated before October 1, 2011, the court will not be entitled to reduce the penalty clause unless article 1070 of the old Civil Code is applied.

For the penalty clause stipulated after this date, independently on the due date of the main obligation, the court can interfere to reduce it according to article 1541 of the New Civil Code.

7. Conclusions

The penalty clause brings to the creditor the advantage of not having to prove the existence and value of the damage in case the debtor fails to perform the contractual obligations. In the economic agreements the penalty clause is compulsory; the penalties are usually established by the law, and they can be neither removed, nor reduced, but the parties are entitled to increase their amounts or to establish penalties for situations unpredicted by the law. Also, in economic contracts the creditor has the right and obligation to require indemnities until the full compensation of the damage in case it is not covered by the amount of the penalties.

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