PENALTY CLAUSES IN COMMERCIAL CONTRACTS: MUCH MORE THAN MEETS THE EYE.

Background

In general, contracts establish rights between two or more persons, on the basis of which one party is obligated to perform (debtor) and the other is entitled to that performance (creditor).

In a contract, either party can be debtor and/or creditor depending on the specific obligation. For instance, a real estate purchase agreement includes mutual obligations for both seller and buyer. On the one hand, the seller is entitled to payment of the purchase price (creditor) and the buyer is obligated to pay (debtor). On the other hand, the buyer is entitled to delivery (*levering*) and transfer (*overdracht*) of the property (creditor) and the seller is obligated to comply accordingly (debtor).

Commercial contracts are not any different in this regard.

If the debtor fails in the performance of one of his obligations (non-performance, partial performance, inadequate performance, late and/or incomplete performance), the creditor can, among other things, request performance of that obligation or claim compensation. These options are available to the creditor by law.

If compensation is the goal, it takes several steps to reach the point at which compensation is received. This will be further explained below.

If the obligation can still be performed, the debtor must be in default. In addition, the creditor needs to prove the non-performance, the existence and the amount of the damages, and the relation between the cause of the non-performance and the damages. Sometimes the amount of the damage cannot be determined (e.g., in a sales contract, the object sold will often have the same value as the purchase price, so the cancellation of the sale does not automatically cause a loss to the buyer). If parties go to court, this aspect may lead to lengthy and costly proceedings.

How can the creditor prevent this process as much as possible?

By including proper penalty clauses in his commercial contracts in advance.

This article provides a brief introduction on penalty clauses in commercial contracts, the application thereof, circumstances to consider when negotiating and drafting, and the benefits of including such clauses.

Please note that this article is written from the perspective of the creditor and is a general description of penalty clauses under Curaçao law. It is not a specific advice on strategy in a particular contract or case.

What are penalty clauses?

Simply put, a penalty clause is a payment or other obligation in case of failure in performance by a contracting party. Any clause which provides that a contracting party – should he fail in the performance of a contractual obligation – must pay a sum of money or perform another obligation, is considered a penalty clause.

Penalty clauses function:

i) as a sanction for the non-performance and/or
ii) to determine the amount for compensation of damages.

The first function provides an incentive for the debtor to comply with his obligations. The latter provides release for the creditor of any burden of proof about the existence and the amount of the damages (to be) suffered.

How are penalties applied?

As a main rule, a contractual clause in a commercial contract is interpreted by the reasonable meaning given to it by the parties. Its interpretation also depends on what the parties can reasonably expect from each other in that regard, taking into consideration all circumstances of each case.

However, case law shows that courts can attribute great significance to the wording of the clause, especially in contracts between professional parties. Therefore, the wording must be clear and the specific legal consequence (e.g., payment of a penalty) must be included in the clause.

Penalty clauses regulated by law

If the scope of a contractual penalty clause is not clear, the clause must be interpreted in favor of the debtor. The law states that:

- the creditor cannot demand performance of both the penalty clause and the obligation to which the penalty clause relates (except if the penalty concerns timely performance of the main obligation or if the penalty aims to urge performance of the main obligation);
- whatever is due based on the penalty clause replaces damages due by law (statutory compensation); and
- the creditor may not demand performance of the penalty clause if the failure of the obligations cannot be attributed to the debtor (e.g., in case of force majeure).

Penalty clauses regulated by contract

Given the abovementioned restrictions, it is recommended to deviate from the law. Parties could, for example, stipulate that in the event of non-performance by the debtor:

- the creditor has the choice between claiming a penalty and statutory compensation;
- the creditor can claim both a penalty and statutory compensation;
- a penalty only replaces compensation for loss due to delay. Yet, the creditor may claim both a penalty and alternative compensation;
- penalties may also be claimed in the event of force majeure (non-attributable failure);
- actual costs, such as out-of-court collection costs and costs of litigation (instead of the court-approved scale of costs), can be claimed by the creditor; and/or
- statutory or contractual interest on the amount of a penalty must be paid.

Even if a penalty clause is regulated by contract, the debtor may, however, request the court to reduce a penalty if it is evident that fairness so requires. That option cannot be validly excluded in the contract.

Circumstances to consider when negotiating and drafting a penalty clause

If parties end up in court, the court must be reluctant when it comes to reducing the amount of a penalty agreed upon between parties. Reduction can only occur if the amount is manifestly excessive and consequently leads to an unacceptable result. However, the court will take all circumstances of the case into account, such as:

- the (dis)proportion between the amount of the penalty and the actual damage amount;
- the nature of the contract (e.g.: is the use of this specific penalty clause usual in this specific contract?);
- the content and scope of the penalty clause (e.g.: is the wording of the penalty clause clear? Is there a maximum to the penalty amount?);
- the circumstances under which the penalty clause has been invoked by the creditor (e.g.: the gravity of the violations, the extent to which the debtor is to blame for the violations, the extent to which the debtor was aware of the breach of the penalty clause etc.);
- the capacity of the parties (e.g.: are parties acting in their business or personal capacities?);
- the circumstances under which the penalty clause has been created (e.g.: did parties negotiate about the content and the amount of the clause? Did parties discuss the reason behind a high penalty amount?); and/or
- whether one penalty amount is applied to widely varying violations with(out) making distinction between bigger and smaller violations.

The creditor should at least consider these circumstances when negotiating and drafting a penalty clause. It is then less likely that the court will (considerably) reduce the amount of the penalty.

Why include a penalty clause?

It aims to provide legal certainty and prevent needless litigation in court, saving you and your business time, hassle and money.

As for the debtor? He will think twice about not complying with his obligations.

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Do you have a contract or specific clause that you would like to have reviewed, drafted, or litigated about? If so, feel free to send an e-mail to:

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