



Penalty clauses... Should they be applied literally, or can they be subject to moderation by a Judge?

Judgement of the Supreme Court, Civil Chamber, of 12 July 2018

Penalty clauses

In commercial agreements the parties usually include clauses to regulate the consequences of contractual breaches. When this kind of clauses foresee the payment of compensations and penalties by the breaching party, they are called “penalty clauses”. They have a twofold objective: to discourage the breach of the agreement and, in the event such breach occurs, to protect the compliant party.

The Spanish Civil Code allows penalty clauses to be moderated in Court. Therefore, these clauses might not be applied literally in accordance with the provisions contained in the contract. Instead, a Judge can modify its application and scope. Thus, it is crucial to be certain about when a penalty clause inserted in the contract will be applied literally and when it is possible that the Judge moderates the terms of agreed penalties.

Different interpretations

The Spanish Civil Code establishes that a Judge may moderate penalty clauses when the non-compliance foreseen in the contract to which the penalty is linked, is different from the non-compliance that actually took place. This is the case, when, for example, a penalty is established for a total breach and what in fact has occurred is a partial breach. Despite the clarity of the provisions contained in the Civil Code, it is not strange to find Judgements moderating freely agreed penalty clauses, in cases different from the ones allowed in the Civil Code.

In this regard, it is common to find Judgements in which the judge moderates penalties based on, for example, “the need to avoid an unjust enrichment”, or “the will to correct situations in which the penalties are clearly disproportional, and compensation is excessive compared to the actual damage”.

Supreme Court’s position

By means of this Judgement, the Spanish Supreme Court reminds us that penalty clauses may only be moderated when the contractually foreseen breach differs from the actual breach.

In all other cases, even when the payment of the penalty is burdensome for the non-compliant party or when the amount of the penalty is higher than the actual damage suffered by the compliant party, the literal will of the parties -as expressed in the agreement- shall prevail. In this regard, the Supreme Court highlights that, in accordance with the Civil Code, agreements are the law between the parties and they must be honored as such.

The Supreme Court states that the interpretation of the provisions contained in a contract must be done carefully. In particular, the Supreme Court points out that although there are well-intentioned interpretations which might seem reasonable and fair, they are simply unacceptable if not in accordance with the law.