

## **Freedom of contract and penalty clauses**

Madrid, June 2022

The Spanish Supreme Court (SC) has applied its settled doctrine on the scope of courts' power to moderate penalty clauses in an interesting case regarding the sublease of movie theatrical premises<sup>1</sup>.

In 2003 Starboard, which managed a shopping and leisure centre in Cádiz (Spain), leased certain premises to UGC Cine Cité for a period of fifteen years. The parties agreed that, as this term was essential for the lessor, in case of early termination due to a breach of contract by the lessee (including the stop of the theatre's operation) it would have to pay all the remaining rents until the agreed termination date, subject to a cap of two years' rents. UGC provided a first demand bank guarantee for the maximum amount of the penalty.

In 2011 UGC subleased the premises to Cinesa until the end of the fifteen-year period provided for in the lease contract with Starboard, *i.e.* until 2018. This term was also defined as essential for the sublessor and the same penalty clause (up to two years' rents) was agreed.

In November 2014 Cinesa stopped running the theatre, left the premises and unilaterally terminated the sublease agreement.

Because of the theatre's closure, in January 2015 Starboard decided to early terminate the lease agreement with UGC and enforced the bank guarantee for an amount of two years' rents (over € 2.2 million). UGC then filed a claim against Cinesa demanding payment of the same amount pursuant to the penalty clause of the sublease agreement.

A first instance court partially upheld UGC's claim. It argued that Starboard had leased the premises to another company in February 2015 (four months after Cinesa left) and UGC could have done the same; thus, Cinesa should pay UGC only four months of rent, despite the penalty clause.

The Cádiz Court of Appeal (CCA), however, revoked this judgment and ordered Cinesa to pay the whole penalty (over € 2.2 million) to UGC. Cinesa appealed the CCA's ruling, but the SC confirmed it.

The SC reminded that penalty clauses, including punitive ones, are generally allowed under Spanish law and that, according to settled case-law, a penalty can only be moderated if (i) it is extraordinarily higher than the damages reasonably foreseen at the time of the agreement or (ii) the latter turn out to be extraordinary higher than the actual damages due to an unpredictable change of circumstances.

---

<sup>1</sup> Judgment 317/2022 dated 20 April 2022.

The SC considered that the penalty provided for in the sublease agreement between UGC and Cinesa should not be reduced pursuant to the mentioned case-law for the following reasons:

- (i) Both parties were companies with relevant businesses that negotiated their contracts freely and, presumably, duly assisted by highly qualified advisors.
- (ii) They expressly stated that the term of the sublease agreement was *essential* for UGC.
- (iii) The terms (until 2018), termination events and penalties (up to two years' rents) of both the lease and the sublease agreements were identical. This shows that the penalty provided for in the sublease agreement was aimed at Cinesa holding UGC harmless should a breach of contract by the former ultimately entitled Starboard to early terminate the lease agreement with UGC and enforce the bank guarantee delivered by the latter, as indeed happened.
- (iv) Furthermore, UGC could not be blamed for not having subleased the premises to another company because Starboard had previously terminated the lease agreement and thus UGC was no longer a lessee.