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Breach of condition precedent clauses and need to precisely draft termination and penalty clauses

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Facts

Two preliminary sale agreements were signed with the same buyer. The first preliminary sale agreement signed with the seller contained several conditions precedent. One of these consisted of the obligation for the buyer to take out a bank loan. Its proof of acceptance or refusal had to be submitted before 28 February 2017. This first preliminary agreement also contained a penalty clause.

The second preliminary sale agreement with the seller contained the same condition precedent related to the obligation of the buyer to take out a loan, with its proof of acceptance or refusal to be submitted by 30 March 2017 at the latest. The parties had also included the same penalty clause as in the first preliminary sale agreement.

The buyer informed the sellers that he was unilaterally waiving the clause relating to the granting of the loan. Then, on 8 June 2017, the sellers informed the buyer that they were rescinding both preliminary sale agreements by registered mail because the buyer had committed gross misconduct for which he was liable. They also requested that the buyer be ordered to pay the amount of damages in accordance with the penalty clause.

In this rare circumstance, the buyer brought an action against the sellers before the District Court of Luxembourg, seeking to have the two preliminary sale agreements declared valid and thus conclude the sale.

Decision

In its decision of 12 March 2019, the District Court of Luxembourg concluded that the preliminary sale agreements had been terminated due to the buyer's misconduct. The first judge ordered the buyer to pay damages according to the penalty clause.

The Court of Appeal confirmed the first-instance judgment and gave more details in its ruling of 2 July 2020.

The District Court of Luxembourg, on 12 March 2019, and the Court of Appeal, on 2 July 2020, agreed that the condition precedent clauses relating to the financing of the transaction were stipulated in the best interests of both parties involved. Therefore, the buyer could not unilaterally waive them.

Lapsing and exception to lapsing

In principle, the breach of a condition precedent clause results in the lapsing of the agreement.

The difference between nullity and lapsing is that lapsing affects an agreement that was initially valid. Lapsing does not have any retroactive effect.

Moreover, the Court of Appeal pointed out that lapsing is not automatic; it exists only as regards the party against whom it is asserted when pronounced by a final judicial decision.

However, the judges noted that there is an exception to the lapsing of an agreement.

Referring to article 1178 of the Civil Code, the judges held that the debtor of a condition precedent is obliged to cooperate loyally so that the condition can be fulfilled. This article also states that if the obligation to cooperate loyally is breached – and that proof is provided to attest it – the condition is deemed fulfilled.

In the case at hand, the judges held that the buyer had not taken any steps to obtain a loan or even any equivalent financing. In doing so, the buyer was at fault.

The appeal judges considered that the most appropriate sanction for the buyer's misconduct was to consider the financing clause as having been fulfilled. Therefore, the preliminary sale agreements were not lapsed.

Termination of agreement in absence of termination clause

The next question the judges answered was whether the selling parties could claim that the preliminary sale agreements were terminated due to the buyer's misconduct and could thus demand the payment of damages under the penalty clause.

The appeal judges first recalled that penalty clauses survive lapsing and the termination of the agreement. They also stated that the amount indemnified on this basis could not go beyond what was stipulated in the penalty clause.

The judges first recalled that, in principle, the termination of an agreement was judicial. The judges ruled that the termination of an agreement depended on the seriousness of the non-performance of the contractual obligations.

However, there are two exceptions to this principle.

Termination clause

The parties may include a termination clause in their agreement that provides for automatic termination. However, for this clause to be effective, it cannot be a possibility but an inevitable consequence. Moreover, the obligation, whose breach is likely to lead to termination, must be precisely stated. Thus, the drafter must be careful to write the clause in clear and precise terms.

The judges considered that the preliminary sale agreements did not contain a termination clause, because the terms used were not precise. As a matter of fact, the parties had not defined the misconduct that would necessarily lead to termination. Indeed, the preliminary sale agreements did not specify the breaches of contract that would lead to termination.

Unilateral termination in case of serious misconduct

The judges of appeal accepted that unilateral termination by one of the parties to an agreement is possible in the event of serious misconduct by the other party.

In this case, the judges held that the buyer had breached his duty of loyalty because he had not done anything at all to fulfil his loan obligations. He had not even taken steps to obtain a loan or an equivalent guarantee.

The Court, nevertheless, recalled that the termination had been made at the risk of the party who availed himself of it. The judges carry out an a posteriori review of the validity of the termination in the event that the opposing party challenged it.

Comment

This judgment highlights the need to draft termination clauses cautiously and precisely to avoid the intervention of judges who have sovereign discretion as to the seriousness of the breaches.

It also highlights the importance of penalty clauses, as judges simply retain the amount obtained in enforcing such clauses without being able to go beyond or below it. The parties must, therefore, carefully anticipate the precise method of calculation so that the amount obtained effectively covers potential damages.

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