

## 112090 - Are Penalty Clauses in Contracts Permissible?

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### the question

I have an import-export company; I import goods from abroad and sell them to dealers in my country. What is the ruling on the penalty clause that compels a customer to pay compensation if he is late in paying off the price of the item, and also requires him to pay compensation for the expected profit in some cases? If I am compelled to comply with this penalty clause, is it permissible for me to stipulate it for my customers too?

### Summary of answer

Penalty clauses in financial contracts are permissible, apart from contracts in which the original commitment is in the form of credit (debt). It is not permissible, for example, to stipulate that the one who buys goods by instalment must pay something additional to the price if he delays payment, because this additional cost is in addition to the debt he owes, and that is Riba.

### Detailed answer

The [penalty clause in financial contracts](#) is permissible, apart from contracts in which the original commitment is in the form of credit (debt).

It is not permissible, for example, to stipulate that the one who buys goods by instalment must pay something additional to the price if [he delays payment](#), because this additional cost is in addition to the debt he owes, and that is blatant Riba. Apart from credit, with regard to commitments it is permissible to stipulate a penalty clause requiring compensation based on the actual harm.

It says in a statement of the Islamic Fiqh Council concerning penalty clauses:

- “The [penalty clause in law](#) is an agreement between the two parties to a contract to work out the compensation that will be due to the one to whom the condition stipulates compensation should be given for harm that befalls him, if the other party does not fulfil the commitment made, or delays fulfilling it.
- The Council confirms its previous statements with regard to penalty clauses in its statement on selling on credit (no. 85, 9/2) in which it says, “It is not permissible to stipulate a penalty in the event of delay in payment for goods bought on credit, because credit is a form of loan, and it is not permissible to stipulate additional payment in the event of delay in paying off a loan”; in its statement on production to order (no. 65, 3/7), in which it says, “It is permissible for a production order to contain a penalty clause stating what the two parties have agreed upon, unless there are circumstances beyond their control”; its statement on [selling by instalment](#) (no. 51, 2/6), in which it says: “If the purchaser (who is buying on credit) delays an instalment and does not pay it at the appointed time, it is not permissible to compel him – whether by prior condition or otherwise – to pay anything more than the sum owed, because that comes under the heading of Riba, which is prohibited.”
- It is permissible for the [penalty clause](#) to be attached to the original contract, or to be determined in a subsequent agreement, before any problem arises.
- It is permissible to stipulate a penalty clause in all financial contracts, except contracts in which the original commitment is a kind of loan, because that comes under the heading of blatant Riba.

Based on that, this clause is permissible – for example in deals made with contractors, import contracts for importers, production orders for manufacturers (sellers), if they do not fulfil their commitment or delay fulfilling it.

Penalty clauses are not permissible, for example, in the case of sale by instalments, [if the debtor \(purchaser\) delays payment](#) of remaining instalments, whether that is due to financial difficulty or are delays for no obvious reason. They are not permissible in production contracts for the purchaser, if he delays paying what is due from him.

- The harm for which it is permissible to pay compensation includes actual financial harm and what the affected party incurs of real loss and what he misses out on of certain earnings. That does not include intangible harm.
- The penalty clause is not to be implemented if it is proven that the one on whom it was stipulated was unable to comply due to reasons beyond his control, or it is proven that the one in whose favour it was stipulated was not harmed by the failure to fulfil the contract.
- It is permissible for the court, on the request of one of the two parties, to amend the amount of compensation due, if there is a reason to do so or if it was exaggerated.” (From Qararat Al-Majma` (p. 371), published by the Qatari Ministry of Awqaf (Islamic Endowments))

Something similar was also stated by the Council of Senior Scholars in the Kingdom of Saudi Arabia, as it says in Majallat Al-Buhuth Al-`Ilmiyyah (2/143), after quoting research on penalty clauses:

“The Council states unanimously that penalty clauses that are sometimes included in contracts are valid and must be adhered to, unless there is an excuse for not meeting this condition that carries weight according to Shari`ah; in that case the excuse becomes a reason to waive the commitment to this condition until the excuse is no longer there.

If the penalty clause stipulates compensation that is too much according to what is customary, because it is intended to be a financial threat, and it is far removed from the guidelines of Shari`ah, then the matter should be reviewed in the light of what is fair and just, on the basis of what was missed of benefits or what was incurred of harm.

In the case of dispute, estimation of that should be referred to the Shar'i judge via people of experience and understanding, acting in accordance with the verses in which Allah, may He be Exalted, says (interpretation of the meaning): “and that when you judge between men, you judge with justice” [An-Nisa' 4:58] and “and let not the enmity and hatred of others make you avoid justice. Be just: that is nearer to piety” [Al-Ma'idah 5:8], and the

words of the Prophet (blessings and peace of Allah be upon him): “There should be neither harm nor reciprocating harm.”

Thus it becomes clear that the purchaser may stipulate a penalty clause in the event of delay on your part in delivering the goods at the time agreed upon, and you do not have the right to stipulate this condition on him if he delays paying the balance owed. Yet, you can also stipulate this penalty clause on the company that exports to you, if they fail to fulfil the terms of the contract as agreed upon between you.

And Allah knows best