THE PENALTY CLAUSE. CONVENTIONAL WAY OF ASSESSING DAMAGES

FLORIN LUDUŞAN*

Abstract
Penalty clause is one of the most important and frequent changes by convention of the parties of the legal status of contractual liability. The parties may agree on the amount of damages, before the damage, by a clause in the contract contents or a separate convention, in case of failure, improper performance or delayed performance of the contractual obligations by the debtor. The purpose of this research is to analyze the concept and advantages of inserting the penalty clause in contracts. Also the study aims to delimitate the penalty clause of other similar institutions.

Keywords: *penalty clause, contract, contractual liability, pledge, alternative obligation*

Introduction:

Penalty clause has its origins in the principle of contractual freedom. According to this principle, the parties are free to sign any contracts and to determine their content within the limits imposed by law, public order and ethics. (Art. 1169, The New Civil Code). Thus, the free will of the contracting parties remains sovereign and values as law.

The contractual liability issues as penalty clause inserted into contracts is of perennial novelty, the contracting parties being free to assess their compensations by agreement. The Penalty clause has a contractual nature. Thus, as a convention, it must meet the conditions of validity required by law.

The legal contractual nature of penalty clause creates the possibility of the parties to modify and even to terminate it by mutual agreement. Therefore having a a legal and contractual nature, the penalty clause should be inserted in a contract embodied in written form.

The Parties, in performance of the contract concluded between them, have the whole interest to provide shelter for any damage likely to suffer as a result of non-performance or defective performance of the obligations incumbent upon the other party engaged in the same legal agreement

The paper includes:

Defining penalty clause of the 1864 Civil Code **and the New Romanian Civil Code.**

The main legislative guidelines regarding the penalty clause, which resulted in doctrinal and jurisprudence interpretations, were the provisions of the old Civil Code from 1864, Articles 1066 to 1072.Penalty clause has been defined by the old Civil Code in art.1066 as *"Penalty clause is that by which a person, to give assurance for the performance of an obligation, binds to give a something in case of failure by his party. "*

The new Civil Code enshrines the legal institution of the penalty clause in art. 1538 - 1543, defining the penalty clause (Art. 1538 Paragraph 1) in the following terms: *"penalty clause is that by which the parties stipulate that the debtor is committed to a particular benefit for non-performance of his primary obligation."*

Advantages and disadvantages to incorporate the penalty clause in contracts.

The Penalty clause provides the advantage of allowing the parties and not the court to choose the amount of compensation in case of a damage suffered, thus the parties shall be from the

* Ph. D. candidate, „Titu Maiorescu" University, Bucharest, (project no. POSDRU/CPP107/DMI 1.5/S/77082; email: florinludusan@yahoo.com).

beginning aware of what and how much it shall cost if they do not meet their obligations, in this point of view it not being only a mechanism of defense against harmful consequences of a default, but also coercion, both legal and moral, without leaving the parties in hope that they will not pay or will pay much less for "breaching" the contract.[1]

Within the contractual relationship, throughout the contract or by a separate agreement, after the conclusion of a contract, but before the default, the parties have the opportunity to determine the amount of damages due by the debtor as failure to perform his contractual obligations.[2]

Also, in the assumption of inserting a penalty clause in contracts, the injured party is exempt from a long, costly and uncertain legal procedure. It can thus be avoided a trial between the contracting parties to establish the due compensation for the damage caused to the creditor by non-performance of the contractual obligations.

The creditor receiving penalty clause is exempt from the requirement to prove the injury suffered by willful misconduct of the main obligation. This clause gives the creditor the option between forced execution in nature of the main obligation and forced execution of the penalty clause. The choice shall be made by the creditor and is not within the debtor's freedom of choice.[3]

Therefore, the parties are free of any evidence to the existence and extent of the injury and thus of the amount of damages owed by the debtor. The creditor must prove only the non-performance, the defective performance or late performance of the contractual commitments undertaken by the debtor.

In the event that the indemnity established is less than the actual injury, the liability of the debtor is reduced by effect of the penalty clause.[4]

We may conclude that the usefulness of the penalty clause, expression of the principle of contractual freedom, results from exempting the parties of any evidence on the existence and extent of the damage and the amount of damages owed by the debtor, and in avoidance of a possible legal dispute between the parties covering the settlement of the damages owed by the debtor to the creditor as a result of the damage caused.

Nevertheless the Penalty Clause has drawbacks. Thus, the debtor of the obligation performed improperly can be determined either for economic reasons or because the creditor's bad faith to set very high amounts in the penalty clause which can lead to unfair situations with injurious effects on him if the clause is enforced.[5] Likewise, if the amount determined by penalty clause is too small, it gives the debtor a means or reason to deliberately evade the execution of duties. This finding is particularly applicable when the penalty clause is less than the benefit that the debtor gets from non-performance of the contract.[6]

Delimitation of penalty clause from similar institutions.
Penalty clause and pledge

The pledge contract is a contract under which the debtor or a third party submits to a creditor or a third party a movable good, tangible or intangible, to secure the fulfillment of obligations. [7] In

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[1] Dascălu D.N., *Issues of Penalty Clause in Civile Contracts from the Perspective of the New Civil Code*, Acad. Andrei Rădulescu Institute of Legal Research of the Romanian Academy, Law, State of Law and Juridical Culture, Annual Scientific Paper Session, May 13, 2011, Bucharest, p.464.

[2] S. Angheni, *The Penalty Clause in Civil and Commercial Law*, Oscar Print Publishing House, Bucharest, 1996, p.14.

[3] Turcu I., *Laws Commented on, The New Civil Code, Law no. 287 / 2009, Book V. On Obligations, Art. 1164-1649, Comments and Explanations*, C.H.Beck Publishing House, Bucharest 2011, p.633.

[4] Weill A., quoted by Bârsan C., în *The Penalty Clause in International Commercial Contracts* by Babiuc V., Rucăreanu I., Bârsan C., Sitaru D., Turcu N.- Seclaman, World Institute of Economy, Bucharest, 1985, p.39.

[5] Sângeorzan D.E., *Practical Comments, Civil Liability in Civil and Commercial Matters*, Hamangiu Publishing House, Bucuresti, 2009, p.113.

[6] *Ibid,* p.114.

[7] M.N.Costin, C.M.Costin, *Civil Law Dictionary from A to Z*, Hamangiu Publishing House, Bucharest 2007, p.487.

the old regulation, namely the Civil Code of 1864, the pledge agreement was defined as "Pawn is a contract whereby the debtor delivers the creditor a movable good for debt security" (Art. 1685).

Under the new regulations, Art. 2480 of the New Civil Code stipulates that pledge may relate to tangible goods or securities issued in the materialized form.

Regarding the subject of penalty clause**,** Art. 1538 Paragraph (1) of the New Civil Code provides: "penalty clause is that by which the parties stipulate that the debtor is committed to a particular benefit for non-performance of his primary obligation." This benefit may consist of a sum of money or other goods.[8]

A first difference between penalty clause and pledge is that, for the penalty clause, the object on which it was agreed as its object remains in the possession of the debtor, while the pledge is usually with dispossession. Thus, according to Art. 2481 of the New Civil Code: "The pledge is constituted by delivering the property or title to the creditor or, where appropriate, keeping it by its creditor, with the debtor's consent, to ensure the claim." So, the pledge agreement remains a real contract, its establishment taking place at the time of handing the good or title to the creditor, or when the creditor shall have it in possession, for holding it in order to guarantee the obligation.[9]

Pledgee is a poor owner of the good given in pledge in favor arising three rights for him: *the right to own the good, the right to claim the good pledged to third parties the right of preference.*[10]

Art 2483 and Art. 2484 of the New Civil Code expressly enshrine the right of the pledgee to own the good pledged.[11]

Right to claim the asset from third parties (the prerogative of tracking the pledged asset) is also enshrined in Art. 2486 of the New Civil Code which provides that: "Subject to rules regarding the acquisition of movable property by possession of good faith, the pledgee may request reimbursement of the asset it holds, unless the asset had been taken over by a or senior mortgage lender or the takeover occurred in the procedure of forced execution." So, when the asset pledged is no more in the possession of the pledgee, he may request restitution from the one who holds it, except for the cases: a) the conditions relating to the acquisition of mobile assets by possession in good faith are met (Articles 937-939 of the New Civil Code), b) those in which the property was taken over by a senior mortgage lender, c) those in which the takeover occurred in forced execution proceedings.[12] Therefore, the prerogative of tracking consists of the opportunity of the pledgee to claim reimbursement of the asset from any person who would hold it.

The right of preference. In relation to unsecured creditors, the right of preference grants creditor the possibility to be paid with priority of the price of the pledged asset and subsequently capitalized. The right of preference stems from the essence of any real right and the right of pledge is an ancillary real right together with the mortgage, privileges and the right of retention.

Therefore results *a second essential difference* between penalty clause and pledge**.** The creditor of the obligation with penalty clause is an unsecured creditor, which comes in competition

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[8] Adam I., *Civil Law. Obligations. Contract.*, C.H.Beck Publishing House, Bucharest, 2011. p. 709.

[9] *Juridical Instruments, New Civil Code, Notes, Correlations, Explanations*, C.H. Beck Publishing House, Bucharest, 2011, p.886.

[10] Găina A.M., *Real Estate Warranties for Execution of Civil and Commercial Obligations*, Universul Juridic Publishing House, Bucharest, 2010, p.63.

[11] In Art. 2483 the New Civil Code provides that: "Owning the asset by the pledgee should be public and unequivocal. When to third parties is created the appearance that the debtor owns the asset, the pledge cannot be opposed to them", and Art. 2484 of the New Civil Code: "With the approval of his debtor, the creditor may exercise detention through a third party, but this detention does not provide ownership of the pledge until the moment he receives the document acknowledging the pledge."

[12] See: *Juridical Instruments, New Civil Code, Notes, Correlations, Explanations*, C.H. Beck Publishing House, Bucharest, 2011, p.887.

with the other creditors of that debtor [13], not being the holder of a real right over the property subject to penalty clause and not having tracking right and right of preference on the asset.[14]On the other hand, the pledgee being the holder of a real right over the asset that is subject to a pledge agreement acquires the three powers, namely, the right to own the asset, the right to claim the asset pledged to third parties the right of preference.

A third difference between the object of the the penalty clause and that of the pledge is that for pledge the object of pledge may be proposed for sale with the purpose of sufficiency for creditor or may be turned over to the property of creditor by the decision of Court. In the case of the penalty clause, the size of the actual damages sought by the lender has no meaning.[15]

Delimitation of penalty clause from alternative obligation.

According to art. 1461 Paragraph 1 of the New Civil Code, "The obligation is alternative when it covers two main benefits, and the performance of one of them releases the debtor from all obligations."

(2) The obligation remains alternative even if, at the time it is born, one of the benefits is impossible to be executed.

Article 1462 (1) Choosing the benefit which will discharge the obligation lies with the debtor, unless it is expressly granted to the creditor.

(2) If the party to which the choice of the benefit is borne does not express its option within the term granted for this purpose, the choice of the benefit shall be borne to the other party.

Art. 1463 The debtor cannot perform, nor can he be constrained to execute a part of a benefit and a part of another.

Art. 1464 The debtor who has the choice of benefit, when one of the benefits has become impossible to be executed even by own fault, is required to execute the other benefit.

(2) If, in the same case, both benefits become impossible to execute, and one's impossibility is due to the fault of the debtor, he is bound to pay the amount of benefit that has last become impossible to be executed.

The alternative obligation assumes that its object consists of two or more benefits, of which, upon selection of one party (the debtor, except when expressly provided that the choice is of the creditor and the situation when, upon maturity, the debtor does not opt), performance of one benefit leads to extinguishing the obligation.[16]

The alternative obligation is characterized by the fact that there is one and the same obligation which consists of two or more main benefits, of which only one must be executed by the debtor to be entirely free of the debt assumed.[17]

Plurality exists, but only subject to the object of the obligation, not in terms of its execution because the execution of one of the benefits has the effect of extinguishing the obligation. The alternative character of obligations with plurality of objects can be determined by the existence of the conjunction "or" between the benefits that the parties determine to be owed by the debtor. It follows that, *in obligatione,* the debtor owes the creditor two or more benefits, and *in solutione* is bound to perform only one of them.[18]

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[13] S. Angheni, *The Penalty Clause in Civil and Commercial Law*, Oscar Print Publishing House, Bucharest, 1996, p.16.

[14] Adam I., *Civil Law. Obligations. Contract.*, C.H.Beck Publishing House, Bucharest, 2011, p. 71.

[15] S. Angheni, op. cit., page 17.

[16] Boroi G., C.A. Anghelescu, *Civil Law Course, General,* Hamangiu Publishing House, Bucharest, 2011, p.73.

[17] L.Pop, *Regulation of the Penalty Clause in the Writs of the New Civil Code*, in "Dreptul" Magazine, no. 8/2011, p.19.

[18] Pop L., *Civil Law Treaty. The Obligations. Volume I. General Juridical Regime,* C.H.Beck Publishing House, Bucharest, 2006, page 205.

For the penalty clause obligations, there are actually two distinct obligation relations, even if the penalty clause agreement is ancillary to the main obligation.[19] Therefore is penalty clause an alternative obligation? The answer can only be negative. The convention which stipulates that penalty clause does not give the debtor a genuine choice between the main obligation and the ancillary one, essentially subsequent and conditioned by default of the primary obligation, but reinstates to him an unique and determined benefit. The penalty clause is in the range of responsibility, punishing non-performance of an obligation, not the obligation itself.[20]

If an *obligation is accompanied by a penalty clause* we are in the presence of two distinct obligations, a principal one and an ancillary and conditional, which expires when the main obligation expires, or *for alternative obligation* failure to execute one of the benefits that are object to it does not have a result in its expiry, it continues to exist as a rule, as pure and simple obligation.[21]

The alternative obligation is therefore an obligation with multiple benefits, one of the benefits having to be executed, upon choice of both parties or one of them, this performance leading to settle the obligation, while the *for the obligation with penalty clause*, there actually are two separate obligation relations, even if the penalty clause agreement is ancillary to the main obligation.[22]

The alternative obligation is distinct from the penalty clause. This is not object of the obligation and is a way of assessment of the damage suffered by the creditor by non-performance according to the title of his claim.[23]

According to Art. 1538 Paragraph (3) of the new Civil Code "the debtor cannot be unbound offering the compensation agreed upon." Thus, *the penalty clause debtor* has no right of option, does not have the possibility to choose and cannot be released from obligation only by performing the main obligation, not being able to provide the penalty clause in return. The debtor *of the obligation with penalty clause* has two contractual obligations, namely *a main obligation* which consists of the obligation to perform the in-kind benefits undertaken and *an ancillary obligation* consisting in payment of money or other benefits set out in the penalty clause. Or, *in the case of alternative obligation,* as explicitly stipulates Art. 1462 Paragraph (1), the debtor has the choice of benefit, unless the creditor had expressly been granted the choice between the two obligations. "Choosing the benefit which will discharge the obligation lies with the debtor, unless it is expressly granted to the creditor. (Art. 1462 Paragraph 1 of the new Civil Code).

The creditor of an *obligation with penalty clause* cannot claim payment instead of the main obligation as long as it is possible to execute in-kind the main obligation. However, in case of non-performance, the creditor can ask for either the in-kind forced execution of the main obligation, or the penalty clause (Art. 1538 Par. 2 of the new Civil Code). Therefore for the creditor there can be the choice of option provided that the main obligation had nor been performed.

While any of the benefits of *alternative obligation* can be executed directly, *the penalty clause* is an indirect execution.[24] In the case of *alternative obligations,* the execution of one of them is sometimes independent of any fault of the debtor, for the obligations to which a *penalty clause* is associated enforcement of this clause is subject to the debtor default for non-performance of the main obligation.[25]

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[19] S. Angheni, *The Penalty Clause in Civil and Commercial Law*, Oscar Print Publishing House, Bucharest, 1996, p.17.

[20] I. Deleanu, S. Deleanu, *Considerations on the Penalty Clause* in "Pandectele Romane", no. 1 / 2003, p.116.

[21] L.Pop, *Regulation of the Penalty Clause in the Writs of the New Civil Code*, in "Dreptul" Magazine, no. 8/2011, p.19.

[22] Adam I., *Civil Law. Obligations. Contract.*, C.H.Beck Publishing House, Bucharest, 2011, p. 718.

[23] Almăşan A.*, Pluralist Obligations*, C.H.Beck Publishing House, Bucharest, 2007, p.12. Almăşan A.*, Pluralist Obligations*, C.H.Beck Publishing House, Bucharest, 2007, p.12.

[24] Almăşan A.*, Pluralist Obligations*, C.H.Beck Publishing House, Bucharest, 2007, p.13.

[25] Deleanu I., Deleanu S., *Considerations on Penalty Clause*, in Pandectele Române, no. 1/2003, p.116.

Penalty clause and optional obligation

The obligation is optional when has its object is one main benefit of which the debtor may be released by executing another predetermined benefit. (Art. 1468 Paragraph 1 of the new Civil Code). The debtor is discharged if, without fault, the main benefit becomes impossible to be executed. (Art. 1468 Paragraph 2 of the new Civil Code)

Voluntary obligation is characterized by the uniqueness of the object of obligation: the benefit which the debtor undertakes is unique. The creditor may require the debtor to execute only the benefit which alone is subject to the obligation. The creditor may therefore only require its execution. The debtor is obliged to execute only one benefit, with choice for the debtor to get unbind by performing another determined benefit.

The other determined benefit the debtor may execute is a *"choice" (in facultate solutionis)*. Therefore: if the main benefit becomes impossible to be performed without fault of the debtor, he shall be freed of obligation; if the main benefit disappears by fault of the debtor, the creditor is only entitled to damages according to general rules.[26]

Therefore, there is only one obligation which "in obligatione" has only one object, and "in solutione" has two objects, the faculty of paying by execution of the other benefit belongs solely to the debtor. Rather, in the case of *obligation with penalty clause* we have two distinct obligations, each with its specific object, the right of choice belongs exclusively to the creditor and is subject to unlawful non-performance of the benefit subject to the debtor's principal debt.[27] "In case of non-performance, the creditor may either request forced in-kind execution of the main obligation, or the penalty clause." (Art. 1538 Paragraph 2 of new Civil Code).

The penalty clause acts as a penalty and is within the reach of the creditor in case of failure or improper performance of contractual obligations of the debtor, while the faculty of the debtor of the *voluntary obligation* is a way of release within the reach of the debtor.

Conclusions

Inserting the penalty clause in contracts remains a challenge for theorists and especially for law practitioners. In the event the contractual debtor does not perform the obligation undertaken, his contractual partner is therefore entitled to obtain the damages under the penalty clause without any claim to prove the existence of the loss and its size. It is sufficient that the parties will have agreed that non-performance or delayed performance of the obligations undertaken cause damage and will have added value to remove, on this plan, any subsequent judicial investigation.

In our study, I tried to stress the need and usefulness of inserting this type of clause in contracts following that in the presence of such clause, the parties to be able from the beginning to determine the amount of damages due to non-performance, poor execution or delayed execution of contractual obligations.

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[26] See: *Juridical Instruments, New Civil Code, Notes, Correlations, Explanations*, C.H. Beck Publishing House, Bucharest, 2011, p.543.

[27] L.Pop, *Regulation of the Penalty Clause in the Writs of the New Civil Code*, in "Dreptul" Magazine, no. 8/2011, pag.19

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