NAVIGANT

CONSTRUCTION

THE CIVIL LAW CONCEPT OF PENALTIES AND THE COMMON LAW CONCEPT OF LIQUIDATED DAMAGES

INTRODUCTION

The Global Construction & Infrastructure Legal Alliance (GCILA) was founded, in part, to provide expertise in construction law from both the civil and common traditions. In furtherance of that goal, GCILA attorneys are preparing a series of comparative monographs on similar concepts. In general, these monographs will present comparisons of French or Swiss civil law and common law from England and New York State of the United States. The reason for the selection of these jurisdictions is that their laws are among the most commonly selected choice of substantive law provisions in international construction contracts.

This article addresses the French concept of "clause pénale," "clause d'astreinte," and the English and New York state common law concept of liquidated damages.

FRENCH CLAUSE PÉNALE

The literal English translation of the French term **clause pénale** is **penalty clause**. In reality, however, clause pénale is something quite different. It is comparable to the England and New York state common law concept of liquidated damages, but with two important differences: 1) it can be used as a punishment or fine for nonperformance, and 2) it can be adjusted upward or downward by a court (or arbitrator) in certain circumstances.

- **Definition**
  Article 1226 of the French Civil Code defines a "clause pénale" as follows: "A penalty is a clause by which a person, in order to ensure performance of an agreement, binds himself to something in case of non-performance."
- **Applicability**
  Articles 1228 and 1229 of the Civil Code provide that the penalty is an alternative to actual performance. Thus, a party can either provide performance or the penalty (Art. 1227), or a party can either accept performance or the penalty (Art. 1229). An exception to this either/or rule concerns penalties for delay, where performance can be required for an assessed penalty (Art. 1229). Article 1230 provides that a "notice of default" is a precondition to assessment of the penalty: "Whether the original obligation contains, or not, a term within which it must be performed, the penalty is incurred only where the one who is bound either to deliver, or to take, or to do, is under notice of default."
- **Adjustment**
  Article 1152 allows a judge (arbitrator) to either increase or decrease the amount of a penalty clause: "Where an agreement provides that he who fails to perform it will pay a certain sum as damages, the other party may not be awarded a greater

or lesser sum. Nevertheless, the judge may even of his own motion moderate or increase the agreed penalty, where it is obviously excessive or ridiculously low. Any stipulation to the contrary shall be deemed unwritten."

At first view, it appears that the ability of a court to adjust the stipulated amount would thwart the parties' intention of having a sum certain in the event of default (e.g., a delay). In practice, though, the French courts are very circumspect with the application of this provision. Judges rarely award penalties greater than 5 percent of the contract price. In any case, the judge determines the amount of the penalty on the basis of the actual loss.

Indeed, the French Supreme Court recently affirmed this precedent[1] when it held that the Court of Appeal could not order the architect and the contractor to pay damages to the employer in excess of the clause pénale without demonstrating the existence of specific damages other than the damages redressed by the amount due under the clause pénale.

Another condition allowing the French courts to adjust the stipulated amount concerns partial performance. Article 1231 provides as follows:

Where an undertaking has been performed in part, the agreed penalty may, even of the judge's own motion, be lessened by the judge in proportion to the interest which the part performance has procured for the creditor, without prejudice to the application of Article 1152. Any stipulation to the contrary shall be deemed not written.

Article 1152 allows for a reduction in the stipulated amount when there is partial performance, such as when a contract has both a substantial and a final completion date and only one daily penalty rate.

FRENCH CLAUSE D'ASTREINTE

A clause forcing a breaching party to comply with his/her duties, and one that includes awarded damages, in addition to the amount that is contractually due, would not legally qualify as a clause pénale under French law, but instead, is a clause d'astreinte conventionnelle — even though this definition is not founded in statutory law (i.e., not included in the French Code). This doctrine was created by the French courts and legal scholars, and the clauses d'astreinte conventionnelle are:

- At times deemed valid and judged applicable without any restrictions (in this respect, they are different from the English law penalty clause since the latter is unenforceable), in which case the amount of the clause cannot be revised by the judge, except in the event of cause étrangére (extrinsic cause), bad faith or the economic hardship of the breaching party
- Sometimes construed as being equivalent to a French penalty clause (clause pénale) because the terms of Article 1226 of the Civil Code are applicable to the French clause pénale, and therefore subject to revision by the judge
- At other times, their validity is challenged, since it is often noted as a way to avoid revision by the judge under Article 1152 of the Civil Code.

COMMON LAW LIQUIDATED DAMAGES

- **Purpose**

  Under English and New York law, a liquidated damages clause is most commonly (although not exclusively) seen in the context of damages for delay. In this sense, both English and New York law can be viewed as a specific kind of clause pénale under the French Civil Code.

  Both set forth, in advance, an amount of damages due in the event of a performance failure. A liquidated damages for delay clause sets forth an amount due in the event of delayed performance, often in the form of a fixed monetary amount due per day past the agreed upon completion date.

  While most commonly applied in connection with delayed performance, liquidated damages clauses, like "clauses pénales," can also be based upon other quantifiable performance metrics, such as the heat rate or electrical output associated with the construction of a power plant.

  New York courts have determined that "[p]rovisions for payment of a reasonable sum for delay in performance of a building and construction contract or for failure to complete performance under it within a specified time are usually upheld as stipulations for liquidated damages, and are not regarded as penalties."[2] The amount should be a good faith estimate of the loss, as of the time of contracting.

- **"Penalty" Unenforceable**

  A long-established base connected to the unenforceability of a liquidated damages clause under New York law addresses the inclusion of a penalty.[3] More specifically, a provision that serves as a penalty is considered contrary to public policy under New York law and therefore, will not be enforced. A liquidated damages provision generally constitutes a penalty if its application results in liability in excess of the damages otherwise recoverable at law, or in excess of actual damages.

1. Cass. 3e civ., 23 October 2012, n° 11-19602, 1255, *Bull.*
2. 36 N.Y.Jur.2e Damages § 175.
3. 36 N.Y.Jur.2d § 162.

A penalty clause seeks to impose liability in excess of actual damages, and typically is not enforced. In this respect, New York law and English law are similar in their treatment of liquidated damages and penalty clauses. It is important to note that the French clause pénale is more in alignment with liquidated damages provisions commonly seen under New York law, and thus generally would be enforceable, despite a nomenclature suggestive of the penalty clauses, generally unenforceable under New York and English law.

- Distinguishing a Liquidated Damages Clause From a Penalty
  Importantly, contractual provisions that limit liability are treated as distinct from liquidated damages clauses. Like the differences noted above, liquidated damages provisions under New York law must establish or set a **lump sum** rather than a cap. Liquidated damages provisions, however, may be viewed as liability limitations in the sense that under New York law, "when an owner and a contractor have agreed that the owner will receive liquidated damages because of the contractor's delay in completing a project, that provision will be enforced as the owner's exclusive remedy, thus precluding any claim by the owner for actual damages."[4]

IMPLICATIONS FOR CHOICE-OF-LAW

In most circumstances, the choice of French, English, or New York law would have little impact on the application of a contract provision setting forth a specified daily or other periodic rate payable for delay. The exception addresses cases where actual delay damages either greatly exceed or fall short of the stipulated amount. Applying French law, a judge or arbitrator would have greater flexibility to adjust the amount. A common law judge or arbitrator could set aside the amount, but not adjust it.

The authors and their respective law firms focus their practice internationally on the types of clauses discussed above and on the construction contracts in which such clauses invariably appear. Should you have a particular interest in these topics, or any questions about them, please contact either author through the GCILA website at www.gcila.org.

4. 36 N.Y.Jur.2d Damages § 175, *citing Int'l Fid. Ins. Co. v. County of Chautauqua*, 245 A.D.2d 1056, 667 N.Y.S.2d 172 (4th Dep't 1997).

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