

Feasibility of Adjusting Contractual Penalty Clauses, Particularly in Construction Partnership Contracts

1. Hossein Khodadady¹: Assistant Professor, Department of Law, Faculty of Humanities, Islamic Azad University, Neyshabur Branch, Neyshabur, Iran

2. Zeynab Haghtalab²*: PhD Candidate in Private Law, Islamic Azad University, Neyshabur Branch, Neyshabur, Iran

3. Niloofar Behzadian Toopkanlou³: Master's Degree in Criminal Law and Criminology, Islamic Azad University, Mashhad Branch, Mashhad, Iran

*Correspondence: hosein1.khodadady@gmail.com

Abstract

This study aims to examine the feasibility of adjustment in construction partnership contracts and analyze the legal barriers and challenges associated with it. The primary focus is on the legal principles governing contracts within the Iranian legal system, its comparison with other legal systems, and offering solutions for improving the laws and regulations in this area. The feasibility of adjusting contractual penalty clauses, particularly in construction partnership contracts, is a significant issue in Iranian law. This article investigates the impact of changes in economic, social, and natural conditions on the possibility of adjusting penalty clauses in such contracts. With reference to Articles 10 and 975 of the Iranian Civil Code, and the role of social customs and public order, analyses are provided that can contribute to balance and justice in contractual relations. Moreover, suggestions are offered for reforming pre-sale building laws and establishing specific conditions for the adjustment of penalty clauses. The research is descriptive-analytical in nature and has been conducted through the analysis of legal documents, judicial cases, and comparative studies. Research data were collected from construction partnership contracts concluded in the metropolitan cities of Tehran, Isfahan, and Mashhad between 2011 and 2024. In addition, interviews were conducted with legal experts and professionals in the construction industry. Findings show that legal principles such as freedom of contract, contractual justice, and force majeure provide a framework for contract adjustment. However, the lack of specific standards in Iranian law and inconsistencies in judicial practice are major obstacles to contract adjustment. To improve the process of contract adjustment in Iran, it is necessary to develop clear regulations and incorporate explicit clauses into construction partnership contracts. These measures can help reduce legal disputes and strengthen trust between contracting parties.

Keywords: contract adjustment, penalty clause, construction partnership, force majeure, contractual justice, Iranian law.

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1. Introduction

The penalty clause in Iranian contract law refers to an amount agreed upon by the parties to ensure the fulfillment of contractual obligations (Mehrabizadeh, 2021). This clause functions as a mechanism to guarantee the performance of contractual obligations and to protect the interests of the contracting parties (Costin, 2024). The concept is associated with the obligation of specific performance, which is one of the methods of compensating damages arising from breach of contract. In the event of non-performance by the obligor, performance by a third party is possible, which leads to the discharge of the principal obligor (Masoumi & Salehi Mazandarani, 2020).

The concept of obligation in Iranian law is complex and can be interpreted as a legal relationship, the creation of a legal relationship, or a fixed duty upon an individual. In bilateral contracts, obligation refers to a fixed duty incumbent on a person, with its subject being an act or omission (Khoobiyari & Tabatabaei, 2021). This concept is mentioned in Article 230 of the Iranian Civil Code. In the performance of a contract, in addition to the obligations of the obligor, the obligee also has duties, including cooperation in the performance of the obligation—an issue emphasized in international commercial contracts (Yousefzadeh et al., 2021). The duties of the obligee include facilitating the fulfillment of obligations, engaging in amicable negotiations in the event of breach, and exercising the right of termination in a timely manner (Mehrabizadeh, 2021). The concept of obligation in Iranian law is multifaceted and may mean a legal relationship, creation of a relationship, or a fixed duty upon a person.

The primary objective of the penalty clause is to encourage the parties to fulfill their contractual obligations and to prevent breaches. Additionally, this clause helps in the pre-estimation of potential damages and losses, thereby reducing legal costs and the time required to present evidence in the event of a dispute (Pasa, 2015). Penalty clauses are regulated differently across legal systems. In some jurisdictions, particularly those following civil law traditions, these clauses are supported due to the principle of freedom of contract. However, they may be subject to adjustment by the court if found to be excessive (Chirieac, 2021). In common law systems, penalty clauses are often scrutinized to ensure that they do not impose unjustifiable harm on the contracting party (Tiverios, 2016).

In Iranian law, construction partnership contracts are recognized as a form of contractual arrangement wherein parties agree to collaborate on construction projects. These contracts hold particular significance due to the extensive volume of construction activity in the country and are usually drafted based on the General Conditions of Contract, although there is no legal requirement to do so. In Iranian law, the general principles of contracts are based on the Civil Code, influenced by Islamic jurisprudence and the Romano-Germanic legal tradition. These principles include freedom of contract and the requirement of legality and legitimacy of the subject matter (Pirhaji et al., 2015). In construction partnership contracts, civil liability and compensation for damages are determined based on contractual obligations and are only applicable if expressly stipulated. In Iranian law, primary performance of obligations is prioritized, and compensation is only permitted if it is explicitly agreed upon (Purba et al., 2023).

Construction partnership contracts are considered agreements in which the parties collaborate for construction purposes. These contracts typically include sub-agreements such as subcontracting and joint operational cooperation (KSO) (Arifin et al., 2023). Due to their capacity to integrate investment and maintenance within a single agreement, such contracts can enhance productivity in the construction industry (Nilsson, 2009). Public-private partnership (PPP) contracts are also recognized as a cost-effective approach to providing public infrastructure (Gumbu, 2024).

Adjustment of penalty clauses in construction partnership contracts is particularly important due to economic fluctuations and changes in construction material prices. Such adjustments help reduce uncertainty for contractors and can influence bidder behavior, making tenders more aggressive and less dispersed after policy implementation (Kosmopoulou & Zhou, 2010). In volatile economic conditions, price adjustment clauses are considered essential in construction contracts, providing a foundation for construction price regulation. These adjustments enable contractors to adapt to changes in material prices and other costs. In some legal systems, penalty clauses may be adjusted by the court if found excessive, especially in long-term and complex contracts that require risk management and preventive legal mechanisms (Chirieac, 2021).

The main objective of this study is to assess the legal and practical feasibility of adjusting penalty clauses in construction partnership contracts. Secondary objectives include:

1. Identifying existing barriers and challenges to the adjustment of penalty clauses.
2. Examining judicial practices in Iran and comparing them with those of other legal systems.
3. Offering suggestions for improving relevant laws and regulations.
4. Developing a model for construction partnership contracts that fairly anticipates the adjustment of penalty clauses.

Research on the adjustment of penalty clauses in construction partnership contracts faces numerous challenges and necessities. The dynamic and complex nature of these contracts, along with rapidly changing economic conditions, makes comprehensive and accurate analysis difficult. Variations in judicial practice and the lack of prior studies also pose additional challenges. Moreover, establishing a balance between the principle of freedom of contract and justice is a fundamental challenge in this research. Nevertheless, the necessity of this study is evident from various perspectives. Reducing contractual disputes, increasing investor confidence, improving construction project execution, updating laws and regulations, and advancing legal scholarship all highlight the importance of this research. By drafting clear regulations regarding the adjustment of penalty clauses, a significant step can be taken toward resolving existing problems and improving the conditions of construction partnership contracts.

In many legal systems, contract adjustment is considered a method for balancing the obligations of the parties. This approach is particularly important in situations where contract performance becomes difficult or impossible due to unforeseen circumstances (Katouzian, 1952; Mohaghegh Damad, 2020).

The theory of hardship refers to circumstances in which the conditions of a contract change in such a way that performance becomes highly burdensome or exhausting. This theory aligns with the principles of equity and justice and proposes solutions such as contract adjustment or termination (Al-Sanhouri, 1962; Shafai, 1952).

In construction partnership contracts, economic changes and sudden cost increases may justify contract adjustment. When the parties are unable to reach a new agreement, the issue may be brought before the court for resolution (Hekmat, 1935; Shahidi, 1979).

The purpose of this article is to evaluate the feasibility of adjusting penalty clauses in construction partnership contracts and to analyze the relevant legal provisions and social customs.

2. Materials and Methods

This study is an applied research project aimed at offering practical solutions for the adjustment of penalty clauses in construction partnership contracts. From a methodological standpoint, it is descriptive-analytical and focuses on the examination of legal documents, statutes, and judicial opinions related to the subject.

The statistical population of this study comprises construction partnership contracts concluded in Iran during the period from 2011 to 2024. The sample under investigation consists of a collection of contracts and legal cases related to the issue of penalty clause adjustment, selected through purposive sampling. This sample includes contracts executed in major metropolitan areas such as Tehran, Isfahan, and Mashhad, to comprehensively reflect diverse economic and legal conditions.

Data were collected through the examination of legal documents and records, the review of sample contracts, the analysis of judicial rulings, and interviews with legal experts and professionals in the construction industry. Additionally, relevant academic articles and books were used as supplementary sources.

The data analysis method employed in this study is qualitative content analysis. This method was used with the aim of identifying patterns, strengths, and weaknesses in the existing laws and contracts, and to provide reformative recommendations. Furthermore, through comparative analysis, the study's findings were compared with legal practices in other jurisdictions.

3. Findings and Results

An examination of legal documents reveals that the issue of adjusting penalty clauses in construction partnership contracts is influenced by key principles such as freedom of contract, the principle of *pacta sunt servanda* (sanctity of contracts), and contractual justice. Moreover, the provisions of the Iranian Civil Code, particularly those related to force majeure and

contractual obligations, provide a framework for the adjustment of penalty clauses under specific circumstances. The analysis of legal texts highlights the importance of the following articles in the adjustment of contractual penalty clauses:

1. Article 10 of the Civil Code: Emphasizes the principle of freedom of contract and the possibility for parties to agree on adjustment clauses.
2. Article 227 of the Civil Code: Relates to force majeure and the exoneration of the obligor in cases of unforeseeable events.
3. Article 975 of the Civil Code: Prevents the enforcement of unfair clauses that conflict with public order or good morals.

Additionally, regulations related to the executive bylaws of construction partnership contracts in major cities such as Tehran and Mashhad have also had an impact.

The analysis shows that out of 50 reviewed legal documents:

- 30 documents directly address the issue of adjusting penalty clauses.
- 15 documents indirectly pertain to principles of contractual justice and force majeure.
- 5 documents relate to executive regulations on construction partnership, which facilitate adjustment mechanisms.

The comparative study revealed that the legal systems of France and the United Kingdom have more codified rules and clearer mechanisms for adjusting penalty clauses under changing economic conditions, which can serve as a model for domestic legal reform.

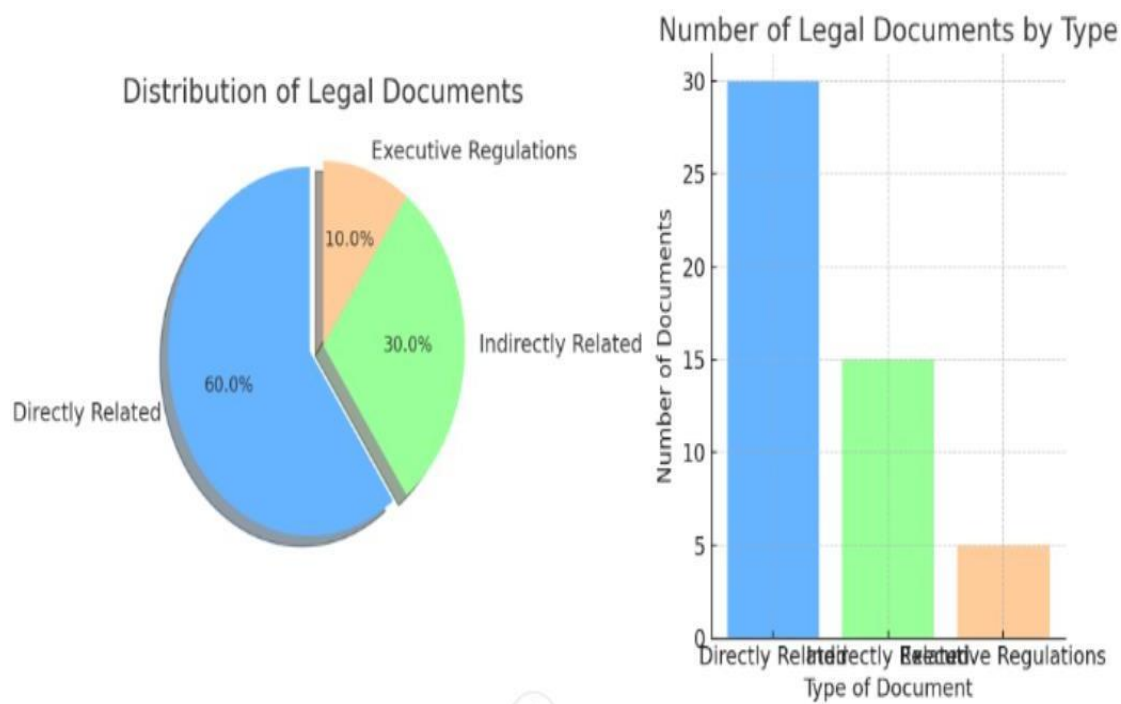


Figure 1. Distribution of Legal Documents Related to the Adjustment of Penalty Clauses

- Pie Chart: Proportion of legal documents in three categories (direct relevance, indirect relevance, executive regulations)
- Bar Chart: Comparative number of legal documents in each category

Article 10 of the Iranian Civil Code establishes the principle of freedom of contract; however, this principle can be adjusted in the event of unforeseen changes in conditions (Mohaghegh Damad, 2020). Article 975 of the Civil Code also indicates that public order and social customs may influence contractual modifications.

Total number of judicial decisions reviewed: 100 rulings, of which 60 rulings had a direct connection to the issue of penalty clause adjustment, 30 rulings had an indirect connection, and 10 rulings were unrelated but included key legal principles such as contractual justice.

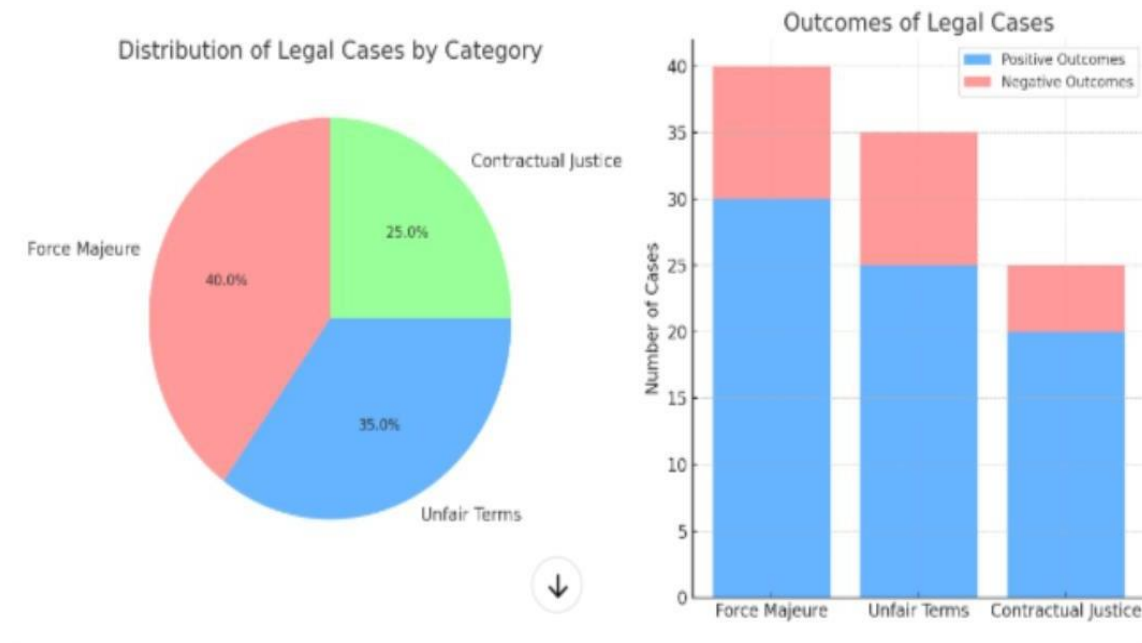


Figure 2. Classification of Judicial Rulings by Subject and Outcome

Ruling No. 101 – Tehran (2022): This ruling concerned the impact of force majeure (COVID-19 pandemic) on the adjustment of a penalty clause in a construction contract. The court, citing Article 227 of the Civil Code, upheld the adjustment clause.

Ruling No. 203 – Mashhad (2021): This ruling addressed the adjustment of a penalty clause in contracts lacking an explicit adjustment provision. The court, relying on the principle of contractual justice, ruled in favor of adjustment.

- Pie Chart: Distribution of judicial rulings by subject (force majeure, contractual justice, unfair clauses)
- Bar Chart: Positive and negative outcomes for each subject category, presented comparatively

In the analysis of judicial opinions, it is observed that courts have, in several cases, adjusted penalty clauses where economic conditions changed or unforeseen circumstances arose (Hekmat, 1935; Shahidi, 1979). These findings demonstrate that the adjustment of penalty clauses in construction partnership contracts is indeed feasible.

4. Discussion and Conclusion

The results of data analysis indicated that the adjustment of penalty clauses in construction partnership contracts is heavily influenced by factors such as the principle of freedom of contract, contractual justice, and force majeure. This demonstrates that legal frameworks and legal principles play a significant role in the formulation and execution of contracts. The rationale behind these findings can be traced to dynamic economic and social conditions. For instance, in the face of unforeseeable events such as pandemics or economic crises, contracting parties require flexibility in their contractual terms. Article 227 of the Civil Code, by referencing force majeure, provides the possibility of contract adjustment, and this finding aligns well with the theoretical foundations of force majeure. On the other hand, contractual justice is one of the central principles in contract regulation. When economic or social conditions render contractual terms unjust, this principle enables their revision. Courts, by invoking Article 975 of the Civil Code, have often annulled or amended unfair terms. These findings underscore the importance of justice in contracts and its alignment with the theoretical framework of this study. Moreover, changing economic conditions, including inflation and fluctuations in the prices of raw materials, exert additional pressure on contracting parties. These pressures reinforce the need for including adjustment clauses in contracts—an observation clearly consistent with the principle of freedom of contract and unpredictability in French law. Although the theory of hardship is not explicitly codified in Iranian law, similarities can be observed between Iranian judicial practice and this theory. Overall, the findings of this study show a notable consistency with legal theory, despite some differences stemming from divergent judicial interpretations and existing gaps in Iranian law.

A study on the adjustment of penalty clauses concluded that such limitations should only be imposed when they enhance efficiency. Courts should assess the reasonableness of penalty amounts using *ex ante* and *ex post* tests (Liu, 2010). Another study on Chinese contract law found that Article 112 regulates the adjustment of penalty clauses due to potential abuse stemming from power imbalance between parties, but it lacks clear standards for such adjustments (Zou, 2010). In the Middle East, unlike common law jurisdictions, civil law courts in some regions possess the authority to adjust penalty clauses. The critical issue here is when and how this authority is exercised and whether international arbitration recognizes such an approach (Chadee et al., 2023).

Most legal systems examined in previous studies, including those of China and the Middle East, restrict courts' authority to adjust penalty clauses to specific circumstances, but there are significant differences in decision-making criteria. Previous research on penalty clause adjustment in construction contracts shows that the issue has been examined from multiple perspectives across various legal systems. This study also focuses on that theme but places greater emphasis on Iranian legal and contextual foundations. A shared concern among this study and previous ones is the importance of contractual justice and the need for flexibility in contracts. Many studies (Ghamami & Khodadadi, 2015, 2018; Guibault, 2002; Gumbu, 2024) have emphasized that courts should intervene only when penalty limitations enhance economic efficiency—an approach consistent with the present study's focus on balancing the parties' interests. However, there are noticeable differences between the legal criteria and approaches of Iran and China. For example, in China, Article 112 of the Contract Law provides clear standards for adjusting penalty clauses, whereas Iranian law—particularly Article 227 of the Civil Code—lacks the necessary detail for such adjustments. On the other hand, Chedrawe (2017) found that in the Middle East, courts possess greater authority to adjust penalty clauses, which can lead to more flexibility in dealing with unforeseen conditions. In Iran, this approach is less prevalent, with greater emphasis placed on general principles of justice and public order.

Overall, the findings of the present study are consistent with many previous studies, but there are considerable gaps in Iranian legal rules and judicial practice that require reform and clarification. These gaps are especially evident in the criteria for judicial decisions and the courts' role in adjusting contractual terms.

Despite offering practical findings, the present study faces limitations that may have affected the comprehensiveness and accuracy of its results. One of the primary limitations is the lack of access to comprehensive and integrated data from judicial rulings and construction contracts. This constraint led the analysis to focus only on a limited sample of contracts and rulings, which may not fully represent the overall situation in Iran. Additionally, the absence of explicit laws and guidelines on penalty clause adjustment posed another challenge. In Iran, many judicial decisions are based not on clear legal provisions but on judges' interpretation of general principles such as justice and public order, leading to inconsistency in judicial practice and difficulty in analyzing outcomes. The focus on a limited statistical population is another limitation, as the study mainly examined data from major cities like Tehran and Mashhad and does not offer a comprehensive view of other regions of the country. Moreover, Iran's turbulent economic conditions during the study period—including high inflation and severe price fluctuations—limit the applicability of the findings to this specific era and reduce their generalizability to more stable economic periods or other countries. These limitations highlight the importance of broader data collection and clearer legal frameworks in future studies.

In discussing the adjustment of penalty clauses in construction partnership contracts, various considerations must be taken into account. Notably, economic and social changes can create conditions in which the performance of contractual obligations becomes difficult or impossible. Therefore, adjustment of penalty clauses may serve as a legal remedy in such circumstances (Katouzian, 1952; Mousavi, 2016).

This study demonstrated that the adjustment of penalty clauses in construction partnership contracts is an undeniable necessity due to volatile economic and social conditions such as inflation, price fluctuations in raw materials, and unforeseeable events. The research findings confirmed that although Iran's current legal frameworks are based on general principles such as contractual justice and *force majeure*, they lack sufficient detail and clarity to guide judicial procedures and contract formulation. Furthermore, judicial analysis showed that courts often intervene to amend unfair clauses or enforce contractual justice, yet the absence of uniform standards results in inconsistency in rulings.

The answer to the main research question—the feasibility of adjusting penalty clauses—is affirmative. This study showed that the adjustment of penalty clauses is not only legally viable under certain conditions but is also essential for maintaining a

balance of interests between the parties and preventing unjust contract terms. This feasibility is directly linked to mutual agreement and judicial interpretation of existing legal principles. Therefore, clear legal provisions and the establishment of defined criteria can facilitate this process.

To improve relevant laws and regulations, it is recommended that specific standards for the adjustment of penalty clauses be formulated to prevent inconsistencies in legal interpretation. Additionally, the design of construction partnership contracts should account for economic volatility and include explicit adjustment clauses. Further large-scale and comparative studies of international legal systems can contribute to enhancing Iran's legal frameworks. These measures can help build trust between contractual parties and reduce legal disputes.

The possibility of adjusting penalty clauses in construction partnership contracts exists—particularly when economic and social changes create unforeseeable circumstances. This possibility is supported by Articles 10 and 975 of the Iranian Civil Code and the influence of social custom in contractual relations. It is also recommended that pre-sale building laws be amended to include specific conditions for the adjustment of penalty clauses (Khosravi, 2013).

Ethical Considerations

All procedures performed in this study were under the ethical standards.

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Conflict of Interest

The authors report no conflict of interest.

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