

Arbitration & ADR - Poland

Public order – compensatory function of penalty clause

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Introduction

On February 13 2014 the Supreme Court (V CSK 45/13) confirmed that the principle of the compensatory function of penalty clauses is a basic rule of public order. The key issue from a commercial arbitration viewpoint relates to the requirements for enforcing a foreign award in Poland and the limits of the public order clause. The judgment has prompted debate on the criteria that should be followed when assessing whether an award complies with the fundamental principles of the Polish legal system. It also provides a basis for examining other legal standards that are covered by the public order clause.

Main legal issues

The main issues which arise in terms of judicial control of arbitral awards are:

- the relationship between public order and mandatory substantive contract law;
- the authorisation of the state court to verify the factual basis of the arbitral award;
- the impact of the *ex aequo et bono* (ie, arbitration based on the principle of equity) competence of the arbitral tribunal to adjudicate the dispute; and
- the Polish courts' understanding of the public order clause.

Limits of arbitrator's powers

Poland is a signatory to the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards 1958 and the European Convention on International Commercial Arbitration 1961. Consequently, arbitration awards have the same legal force as rulings of state courts upon recognition or enforcement by the state court.

In essence, every arbitral award is subject to mandatory judicial control in state court proceedings regarding the recognition or enforcement of an award. According to Article 1214(3) of the Civil Procedure Code, the court will refuse to recognise or confirm the enforcement of an arbitral award if:

- the dispute is not arbitrable; or
- recognition of the award would be contrary to public order.

The limits of an arbitrator's power to adjudicate disputes are, in principle, determined by the arbitration agreement and the mandatory substantive law on contracts. Further, parties may decide that the dispute will be adjudicated *ex aequo et bono*. This is a variation of commercial arbitration in which the parties expressly agree that the arbitrator is not bound by strict rules of contract law and is authorised to adjudicate the dispute on an equitable basis. Nevertheless, arbitrators are always limited by the fundamental principles of public order. Thus, the parties may change the scope of an arbitral tribunal's competence and obligations, but only within the limits of public order.⁽¹⁾ Further, in analysing the compliance of the award with public order, the court does not examine whether the award is based on facts and is compliant with substantive law. Examining whether the facts were established correctly also lies outside the court's remit.⁽²⁾

Public order has no legal definition and therefore depends on the discretionary power of the state court examining the arbitral award *ex officio* in the annulment or recognition proceedings. This is always an *ad casum* (relating to the case or action) decision, according to applicable domestic law. The Supreme Court provided an important interpretational clue by explaining that public order should be interpreted narrowly to cover only fundamental constitutional rules and central principles of procedural

and substantive law.⁽³⁾ Previously, due to the lack of any definition, the interpretation of public order has been much broader than it should have been and has had a different meaning from that in other European jurisdictions, where the notion of public order is limited to the most serious violations of public order.

Standards of mandatory substantive law and public order

The general standards of mandatory substantive law on contracts can be divided into:

- contractual revisions; and
- modification of contractual duties in the event of failure to perform the contract.

Some standards have been recognised by case law as fundamental principles of public order. An indication of which standards are seen as fundamental principles of public order depends on the discretionary power of the state court that examines the arbitral award.

The general standards for contract revision include the following principles:

- *pacta sunt servanda* (ie, agreements must be kept) and the principle of full restitution;
- *rebus sic stantibus* (ie, the adjustment of the contract to changed circumstances) and the exceptional nature of this doctrine;
- *pacta turpem causam continent* (ie, agreements based on unlawful considerations will not be enforced) and the exceptional nature of the doctrine of exploitation;
- *ad impossibilia nemo tenetur* (ie, no one is obliged to perform the impossible); and
- the liability of parties for the normal consequences of their actions under the contract.

The general standards for modifying contractual duties in the event of failure to perform a contract include the following principles:

- the fault and exceptional nature of risk-based liability;
- absolute liability for intentional breach of contract;
- use of the differential method when recovering the unequivocal position of parties;
- a compensatory function of damages and the prohibition of manifestly excessive contractual penalties; and
- the statutory prohibition of certain set-offs.⁽⁴⁾

Supreme Court jurisprudence confirms that one basic principle of public order is the compensatory function of penalty clauses, which should be taken into consideration when mitigating penalties by arbitral tribunals if they are manifestly excessive. While the contractual penalty may exceed the actual damages, it cannot be manifestly excessive. As the Supreme Court stated, the contractual fairness rule and the compensatory nature of liability for damages rule, interpreted in accordance with the constitutional requirement of proportionality (Article 33(3) of the Constitution), oppose penalties aimed at penalising the opposite party – the restrictive function of penalty clause. The Supreme Court also stated that compensation may not lead to enrichment through compensation exceeding the amount of damages.

Case law has held that the following issues should be treated in the same way:

- the authority to impose contractual penalties only in the event of non-performance of the non-pecuniary obligation;⁽⁵⁾
- the prohibition on establishing an interest rate that is higher than the amount regulated in the mandatory provisions;⁽⁶⁾
- the need to establish a deadline for exercising the right to rescind the contract in the contract;⁽⁷⁾
- the principle of restitution;⁽⁸⁾
- the differential method principle;⁽⁹⁾ and
- the principle of regular causal relationship.⁽¹⁰⁾

Comment

Some of the standards of mandatory substantive law discussed have already been declared part of the public order. Arbitrators should take these standards into account when issuing an award, to avoid the risk of the awards being set aside as contrary to the public order. Therefore, it is likely that the remaining standards will be recognised as part of the public order in the future. It is in the best interests of the credibility of arbitrators to take the local public order standards into account, especially when the courts' interpretation of the public order is much broader than it should be.

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Endnotes

(1) The parties may modify the limits of the arbitral tribunal's power to revise the parties' contractual

relationship. The decision of the parties to let the arbitrator adjudicate the dispute *ex aequo et bono* changes only the arbitrator's obligation to issue an award which is compliant with the substantive law analysed, and excludes possible contractual responsibility for the unlawful judgment of arbitrators. The parties cannot change the validity of the public order.

(2) Supreme Court ruling, September 3 2009 (Case I CSK 53/09).

(3) Supreme Court ruling, March 9 2004 (Case I CK 412/03).

(4) Supreme Court ruling, April 28 2000 (Case II CKN 267/00).

(5) Supreme Court ruling, July 24 2009 (Case II CNP 16/09).

(6) *Id.*

(7) Supreme Court ruling, August 11 2005 (Case V CK 86/05).

(8) Supreme Court ruling, September 30 2010 (Case I CSK 342/10).

(9) The correct establishment of compensation requires an earlier explanation of the grounds on which the damage has arisen, as well as the amount thereof. See Supreme Court ruling, September 30 2010 (Case I CSK 342/10).

(10) Supreme Court ruling, October 18 2006 (Case II CSK 123/06).

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