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Principle of Proportionality of Contractual Penalty in Arbitral Awards in Russia

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Eunok Park
Professor, Department of International Trade, Jeonbuk National University, South Korea
Liliia Andreevskikh†
PhD Candidate, Department of International Trade, Jeonbuk National University, South Korea

Abstract

Purpose – When recovered through arbitration a contractual penalty that is disproportionately high can become grounds for challenging an arbitral award or an obstacle to its enforcement within Russian jurisdiction. This article investigates how violation of the principle of proportionality can affect the enforcement and challenging of arbitral awards in Russia. Based on the examination of the current legislation, along with the analysis of recent court cases on the subject, the ultimate object of this article is to discern practical recommendations for Korean practitioners who are looking to challenge and/or enforce arbitral awards in Russian courts.

Design/methodology – The research process included the reviewing of current Russian legislation conducted in concurrence with academic literature review, searching and analyzing recent court cases where the relevant legal provisions and concepts were applied, and formulating practical implications of the research at its final stage.

Findings – Through its relation to the principle of fairness/justice the authors establish the connection between the principle of proportionality and the public policy of Russia. Analysis of recent court cases showed two conflicting trends of whether a disproportionate penalty can be considered a public policy violation. The authors offer practical recommendations on how to substantiate a relevant claim regarding contractual penalty reduction by the court, depending on the desired outcome.

Originality/value – The article contains an up-to-date summary of the legal provisions on the principle of proportionality of civil liability in Russia and identifies the most recent trends in court practice on the issue that is not covered by existing studies.

Keywords: Arbitral Awards, Contractual Penalty, Public Policy Defense, Russian Law
JEL Classifications: K12, K40

1. Introduction

Contract for sales of goods is the basic contract that forms the legal basis of trade. To prevent one's contracting party from breaching a contract, it is common to include a penalty clause: the party that breaches an obligation under the contract is obligated to pay a certain amount of money to the aggrieved party in addition to what is owed under the contract. There are different approaches to penalty clause that exist in civil law and common law systems.

In common law a penalty clause is a contractual provision that obligates the party in breach to pay a significant amount of money to the aggrieved party. Unlike liquidated damages, a penalty is unrelated to the actual damages suffered by the aggrieved party and serves as a punishment imposed on the party in breach. In common law countries penalty clauses are generally unenforceable: a penalty clause which is out of proportion to the legitimate interests

† **Corresponding author:** andreevskikhliliia@gmail.com

of the innocent party may be considered oppressive and, therefore, unenforceable.[1]

In the civil law countries, the approach is different: most civil codes allow for penalties to encourage performance of contractual obligations, and if a penalty is too high or disproportionate to the actual loss or other negative consequences of the breach, it can be mitigated by the court in most jurisdictions. Such jurisdictions include France, Italy, Spain, Germany, Netherlands, Switzerland, Scandinavia, Russia, China, and South Korea.[2] Being a means of ensuring obligations under a contract are performed properly, a penalty clause acquires even more importance in the framework of international trade since it can be a contributing factor to the stability of the international exchange of goods and services.

Russia is one of the countries where an excessive contractual penalty can be mitigated by the court – such provision is stipulated in Article 333 of the Civil Code of the Russian Federation. Under this Article a penalty can be reduced by the court if it is *clearly disproportionate* to the consequences of the breach of an obligation. The requirement for a penalty to be in proportion with the consequences of the breach is the manifestation of one of the key principles of Russian civil law which is the principle of *proportionality of civil liability*. The principle of proportionality is woven into many branches of law: criminal law, human rights law, constitutional law etc. which makes it a fundamental principle of the entire legal system of the state, and therefore, treated as an element of its public policy.

Public policy exception is one of the grounds that can lead to the setting aside of an arbitral award, or to the refusal to recognize and enforce it in a domestic jurisdiction. An arbitral award usually consists of several components: obligation to pay the principal debt, obligation to pay the contractual penalty for breach of contract, the obligation to pay damages, the obligation to pay costs associated with arbitration etc. Very often the penalty component accounts for a large portion of the funds awarded to the plaintiff who then relies on it as a means of compensation for whatever negative consequences they have suffered. At the same time, when Russian national courts resolve claims regarding recognition and enforcement of arbitral awards rendered by both foreign and domestic arbitration institutions, it is not uncommon for the defendant to raise objections based on public policy violation, and in some cases, it is concerned with violating the principle of proportionality of civil liability.

The key objectives of this article are to examine and summarize the main legal provisions regulating the principle of proportionality of civil liability in Russian law, to establish the connection it has with the public policy of the Russian state, and to investigate how it can be applied when challenging arbitral awards and/or applying for recognition and enforcement of awards in Russian domestic courts. The ultimate purpose of the article is to discern practical implications and offer recommendations to legal practitioners in South Korea who seek to challenge and/or enforce arbitral awards within Russian jurisdiction. The structure of the article is defined by the research process which included the reviewing of current Russian legislation conducted in concurrence with an academic literature review, searching and analyzing recent court cases where the relevant legal provisions and concepts were applied, and formulating practical implications of the research at its final stage.

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[1] Thomson Reuters Practical Law Glossary, available at https://uk.practicallaw.thomsonreuters.com/7-107-6986?transitionType=Default&contextData=(sc.Default)&firstPage=true .

[2] Reed Smith LLP (2008). Liquidated damages and penalty clauses: a civil law versus common law comparison, available at https://www.lexology.com/library/detail.aspx?g=d413e9e1-6489-439e-82b9-246779648efb .

2. Principle of Proportionality in Russian Legislation and Literature

2.1. Nature of Penalty and Principle of Proportionality

Under Russian law penalty is the amount of money specified by law or contract which the debtor is obliged to pay to the creditor in case of non-performance or improper performance of obligations, in particular in the event of delay in performance.[3] In both academic literature (Braginskiy, Vitryanskiy, 2011) and commentaries on the Civil Code of Russia there is an agreement on the dual nature of penalty: a penalty clause serves as a way of ensuring that an obligation under a contract is properly performed,[4] and in case of a breach penalty serves as a measure of liability for breaching the contract.[5] The Constitutional Court of Russia has supported such approach.[6] As a measure of liability, a penalty performs two functions: first, to compensate the aggrieved party for the negative consequences they sustain because of the breach, and second, to penalize the party in breach.

There are two types of penalties recognized by the Civil Code: one that is prescribed to be paid by law (usually associated with consumer protection, electricity and gas supply of private households etc.), and the other is a contractual penalty – a penalty that the parties agree to pay in case one of them breaches the contract. Commonly parties to international trade act as businesses pursuing commercial interests, therefore the focus of this article is placed on a contractual penalty.

When a dispute arises, and parties turn to litigation or commercial arbitration, the question that often arises is how to define the amount of penalty to be paid to the aggrieved party. The Civil Code of Russia establishes that basic arrears interest is equal to the Russia Central Bank key rate unless the parties agree otherwise. At the same time, parties can agree on a penalty clause in place of an interest payment obligation.[7] The principle of contractual freedom[8] implies that persons are free in their will to enter contracts and to define such contracts' conditions including the freedom to define the amount of penalty to be paid in case of breach of contract. However, there is a limitation imposed on this freedom by law, to be specific, by the right of the court to reduce contractual penalty under Article 333 of the Civil Code of the Russian Federation:

"1. If the penalty payable is clearly disproportionate to the consequences of the breach of the obligation, the court has the right to reduce the penalty. If the obligation is violated by a person/entity engaged in entrepreneurial activity, the court has the right to reduce the penalty, based on the debtor's application for such a reduction.

2. Reduction of the penalty defined in the contract and payable by the person engaged in entrepreneurial activity is allowed in exceptional cases only, if it is proved that the recovery of the penalty in the amount provided for in the contract may lead to unjustified enrichment of

[3] Article 330 of the Civil Code of the Russian Federation.
[4] Article 329 of the Civil Code of the Russian Federation.
[5] Article 394 of the Civil Code of the Russian Federation.
[6] Constitutional Court of the Russian Federation, Ruling dated October 7th, 1999 No. 137-O; Decision of the Constitutional Court of Russia dated December 21, 2000 No. 263-O; Decree of the Presidium of the Supreme Arbitration Court of the Russian Federation dated October 13, 2011 No. 5531/11.
[7] Article 395 of the Civil Code of the Russian Federation.
[8] Article 421 of the Civil Code of the Russian Federation.

the creditor."

As it follows from the text of the article, the court has the right to reduce the amount of penalty payable to the aggrieved party if the penalty is "clearly disproportionate to the consequences of the breach." Russian courts actively use this right, and it can lead to a significant reduction of a penalty payable under a contract. At risk of a penalty being reduced by the court, Article 333 introduces a requirement for a contractual penalty to be in proportion with the consequences of the breach. Such requirement is a manifestation of a broader principle of the Russian legal system – the principle of proportionality.

The principle of proportionality is a blanket principle that forms respective concepts in various branches of law. For example, in criminal law proportionality means that the punishment of an offender should fit the crime (Fish, 2008; von Hirsch, 1992; Bazhanov, 2017). In international law (Newton & May, 2014) proportionality of international countermeasures states that to legally use force in an armed conflict, it should be proportionate with the injury suffered, considering the gravity of the internationally wrongful act and the rights in question.[9] In human rights law the principle of proportionality means that interference with rights must be justified by reasons that keep a reasonable relation with the intensity of the interference (Sieckmann, 2018).

The omnipresence of proportionality in various spheres of law can be explained through its close connection to the principle of fairness (justice). Several Russian authors conclude that the principle of proportionality is an aspect of the principle of fairness which is the basic principle of law. Migacheva (2014) noted that being based on the Roman concept of "aequitas" (which means uniformity, proportionality, equality) the meaning of fairness (justice) in modern law is closely connected with proportionality and can be understood as balance, correspondence between given and received in the process of social interaction. Arakelyan (2008) proposed recognizing proportionality (for civil law in general) and equivalence (for the relations involving exchange) as general criteria of fairness (justice) as they reflect the dual essence of justice as both a dimensional and value category. In other words, in civil law the principle of fairness/justice is expressed through proportionality, i.e., through the balance between rights and obligations, the balance between what is given and what is received, the invalidity of oppressive transactions, and finally, in the proportionality of a penalty to the consequences of a breached obligation.

2.2. Principle of Proportionality, Public Policy, and Commercial Arbitration

Russia is a party to the New York Arbitration Convention (1958). Under the Convention, an arbitral award shall not be recognized and enforced if the competent authority in the country where recognition and enforcement is sought finds that "the recognition or enforcement of the award would be contrary to the public policy of that country." The Arbitrazh Procedure Code of the Russian Federation contains a provision equivalent to the one in the Convention (1958). Both the law "On International Commercial Arbitration" and the federal law "On Arbitration in the Russian Federation" state that an award can be set aside by the competent court if it finds that the arbitral award is contrary to the public policy of the Russian Federation. Finally, pursuant to the Civil Code of Russia, a rule of foreign law shall

[9] Responsibility of States for Internationally Wrongful Acts. United Nations, 2001.

not be applied in exceptional cases where the consequences of its application would clearly contradict the fundamentals of the rule of law (public policy) of the Russian Federation.

There are two kinds of cases related to international commercial arbitration that can be brought to Russian domestic courts: cases where a party to a dispute is looking to challenge an award with the seat in Russia, and cases where a party is seeking to have an arbitral award recognized and enforced on the territory of Russia. For both types of cases an award can be set aside/refused to be recognized and enforced based on the violation of public policy.

To establish the relationship between the principle of proportionality and the public policy of the Russian state it is necessary to address the definition of public policy under Russian law. One of the first official interpretations of public policy came from the Supreme Arbitrazh Court in 2005[10] and reads as follows: "the public policy of the Russian Federation implies good faith and equality of the parties entering into relations regulated by private law, as well as the *proportionality* of civil liability measures to the guilty offense." The Supreme Court explicitly mentions proportionality of civil liability (that can take form of a penalty, a fine, paying damages etc.) among main elements of public policy.

The most recent definition of public policy was suggested by the Supreme Arbitrazh Court in 2016, reaffirmed by the Supreme Court of Russia in 2019, and since then has been actively applied by Russian arbitrazh[11] courts: "Public policy is constituted by fundamental legal principles that possess the highest imperative value, universality, exceptional social and public significance, and form the basis of the economic, political, and legal systems of the state. Such principles include a ban on committing actions expressly prohibited by the super-imperative norms of Russian legislation[12], if these actions damage the sovereignty or security of the state, affect interests of large social groups, violate constitutional rights and freedoms of individuals."

When comparing the original (2005) and the more recent (2016) definitions, the former reflected the principles of private law while the latter defined public policy through the principles of public law. Although the recent definition of public policy does not explicitly mention it, it still links to proportionality through the principle of fairness (justice) that is recognized as a general principle of law (sometimes even referred to as a metaprinciple), and therefore fits the officially recognized definition of public policy by Russian courts. Fairness (justice) as a value is mentioned in the preamble to the Constitution of Russia[13], it is expressly designated as a fundamental principle of Russian criminal law[14], and is very often referred to by the Constitutional Court in its decisions (Rundkvist, 2022). As mentioned earlier, proportionality is one of the key aspects of the principle of fairness (justice), especially in private law relations.

Returning to the main subject of the article, when a penalty awarded under lawsuit is excessively out of proportion with the consequences of the breach, courts have the right to reduce such penalty by applying Article 333 of the Civil Code. When it comes to challenge

[10] Information letter of the Presidium Supreme Arbitrazh Court of the Russian Federation dated December 22, 2005, No. 96.

[11] Russian domestic courts specializing in resolving commercial disputes hereinafter will be referred to as arbitrazh courts.

[12] Article 1192 of the Civil Code of the Russian Federation.

[13] The Constitution of the Russian Federation available at: http://www.constitution.ru/en/10003000-01.htm .

[14] Article 6 of the Criminal Code of the Russian Federation.

and recognition of arbitral awards, Russian courts can set an award aside or refuse to recognize and enforce an award where it contradicts the public policy of the state. Recognizing that the principle of proportionality of civil liability is part of public policy, failure to reduce a penalty to an acceptable (proportional) amount by an arbitral tribunal can provide justification for setting aside an award or refusing recognition of it by the court. In the following chapter where specific court cases are analyzed it will be demonstrated how Article 333 of the Civil Code is applied when resolving disputes regarding challenging and recognition of arbitral awards.

2.3. Procedural Aspects of Penalty Reduction by Russian Courts

Speaking about the practical application of Article 333 of the Civil Code when resolving disputes, it is necessary to examine the procedural aspects of reducing penalty by Russian courts. In Russian legal literature authors raise questions about the following two issues: whether the court has the right to initiate reduction of a penalty (without the defendant's request), and what the criteria of proportional penalty are, e.g., what guidelines the court should follow when deciding on the acceptable penalty amount.

The issues of whether the court can initiate penalty reduction without a petition from the defendant was often raised until 2011, and there was no unanimous opinion as Article 333 was silent on the matter. First in 2011 the Supreme Arbitrazh Court[15] clarified that penalty can be reduced by the court only based on a petition filed by the defendant, and following the clarification, in 2015, the text of the Article was amended accordingly. According to the most recent amendments, when a breach is committed by a person engaged in entrepreneurial activity (e.g., commercial organizations, individual entrepreneurs and non-commercial organizations engaged in income generating activities) the reduction of penalty by the court is allowed only upon a substantiated petition from the debtor.

After the text of the Article was amended, the Supreme Court of Russia[16] shed light on some of the issues related to the distribution of burden of proof concerned with penalty reduction in court. The burden of proving that a penalty is excessively (unproportionally) high lies on the party in breach, however there is a list of arguments the debtor cannot resort to when substantiating their petition. Such arguments include difficult financial situation, debts before other creditors, seizure of money or other property of the defendant, lack of public funding, non-fulfillment of obligations by counterparties, voluntary payment of the debt in full or in part, dispute resolution, and performance by the defendant of socially significant functions. At the same time, the aggrieved party is under no obligation to prove that the penalty is proportional to the consequences of a breach or that they have suffered damages because of it.

Finally, the aspect of reducing a penalty in court that has the most critical implications when it comes to practical implementation of Article 333 is the criteria of proportionality. When the plaintiff can expect that the penalty under the contract will not be fully recovered and when the defendant can count on the court's "mercy" and have the penalty reduced are

[15] Decree of the Plenum of the Supreme Arbitration Court of the Russian Federation No. 81 of December 22, 2011.

[16] Resolution of the Plenum of the Supreme Court of the Russian Federation of March 24, 2016 N 7 "On the application by the courts of certain provisions of the Civil Code of the Russian Federation on liability for breach of obligations" with changes and additions from February 7, 2017, June 22, 2021.

the questions that most practitioners would like to be answered first. When it comes to criteria of proportionality of a penalty, theoretical criteria and practical criteria can be distinguished.

The theoretical criteria are the general criteria that can be discerned from interpretation of the text of law, and they are often speculated about in academic literature. For example, there is a common opinion that proportionality can be reached when a balance between competing interests of two parties is achieved (Bazhanov, 2017; Kostikova, 2012). To be more precise, when the aggrieved party is compensated for the breach, and the party in breach is penalized without being taken advantage of. Pursuant to the text of Article 333, the main purpose of penalty reduction is to prevent the creditor from unlawful enrichment at the expense of the debtor[17]. At the same time, courts often point out that according to Russian law and clarifications by the Supreme Court, when assessing the proportionality of a penalty to the consequences of an obligation breach, it must be taken into account that no one has the right to benefit from their illegal behavior, and also that the misuse of other persons' money should not be more beneficial for the debtor than the conditions of its fair use[18]. In other words, when reducing a penalty, the court should exercise caution in order not to reduce it to the extent where the party in breach benefits from having breached the contract.

Based on the above, it can be concluded that a penalty is proportional to the consequences of the breach when the three following conditions are present: the penalty compensates the aggrieved party for the negative consequences sustained as a result of the breach, the penalty does not lead to enrichment of the aggrieved party (there is no abuse of the right), and finally, the penalty is not low enough for the party in breach to benefit from their unlawful behavior.

The practical criteria were recommended by the Supreme Court of Russia in order to promote consistency and unification in implementation of Article 333 by arbitrazh courts. When considering the issue of reducing contractual penalty, the courts are advised take into account the following circumstances: the ratio between the amounts of the penalty and the principal debt, duration of breach, the ratio of the penalty accrual rate to key rate of Bank of Russia, lack of good faith on behalf of the creditor, and the financial situation of the debtor[19]. The Supreme Court[20] has pointed out that if the damages caused by the breach of obligation are significantly lower than the accrued penalties, it might be an indication that the penalty is disproportionately high, and the plaintiff might unreasonably benefit from its recovery.

According to the Supreme Arbitration Court's recommendation[21], when deciding on the

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[17] According to the Constitutional Court of the Russian Federation, the right of the court to reduce the penalty where it is disproportionate to the consequences of a breach of obligations is one of the legal methods provided for by law aimed at preventing the abuse of the right to freely determine the amount of the penalty. In other words, it is a way of implementing Article 17 of the Constitution of the Russian Federation, which states that the exercise of rights and freedoms of a person and should not violate the rights and freedoms of other persons (Decision of the Constitutional Court of the Russian Federation of January 15, 2015 N 7-O "On the refusal to accept for consideration the complaint of citizen Parshin Alexander Vasilievich regarding the violation of his constitutional rights by pt. 1 of Article 333 of the Civil Code of the Russian Federation").

[18] Decision of the Arbitrazh Court of the City of Moscow July 24, 2019 Case No. A40-84581/19.

[19] Review of Judicial Practice in Civil Cases related to the resolution of disputes on the fulfillment of loan obligations, approved by the Presidium of the Supreme Court of the Russian Federation on May 22, 2013.

[20] Decree of the Plenum of the Supreme Court of the Russian Federation dated March 24, 2016 No. 7.

[21] Paragraph 2 of the Resolution of the Plenum of the Supreme Arbitration Court of the Russian Federation of December 22, 2011 No. 81 "On Certain Issues of the Application of Article 333 of the Civil Code of the Russian Federation".

amount of a penalty and its proportionality, double the key rate of the Bank of Russia can be used as a criterion of proportionality of a penalty, as well as the average fee for short-term loans for replenishment of working capital issued by credit institutions to business entities at the location of the debtor during the period of breach of an obligation. In either case, the penalty cannot be reduced lower than key rate of the Bank of Russia for each day the payment of the principal debt or performance of another obligation is delayed.

Various circumstances are to be taken into consideration by the court when deciding whether the penalty that the plaintiff is seeking to recover is proportional to the consequences of the breach. Russian authors point out that proportionality to an extent is a "subjective category" (Egorova, 2022; Agahanov, 2022) which means that courts make decisions on a case-by-case basis and exercise a certain level of discretion. Thus, the following section of the article will analyze several cases where the issue of penalty reduction arose in connection with the enforcement or setting aside of arbitral awards in Russian national courts.

3. Court Cases Analysis

3.1. Implementation of the Norms on Reducing Contractual Penalty When Rendering and Challenging an Arbitral Award

3.1.1. Case 1 (Decision of the Arbitrazh Court of Krasnodar Region Case #A32-30780/17 of September 29, 2017)

a) Circumstances of the Case

The Court of Arbitration for Sport ruled that the following amount be awarded in favor of the plaintiff: the total of €950,000 consists of a penalty with accrual at 5 percent per annum – €570,000 (for violation of terms of payment of the principal debt), the principal debt of €210,000 (rental payments for the player in the second season) and €150,000 (rental payments for the player in the third season). The debtor pointed out that the penalty is punitive in nature because its size exceeds the amount of principal debt and damages. Besides this, the debtor pointed out that the accrual of interest on the amount of the fine will lead to double liability for breach of the same obligation.

b) Court's Motivation and Ruling

The foreign arbitration award was rendered based on Swiss substantive law. The Swiss substantive law contains provisions that a court can reduce excessive contractual penalty. Based on these provisions, CAS significantly reduced the amount of penalty prescribed by the contract. The Russian court noted that these provisions of Swiss law correspond to similar provisions of the Russian substantive law, in particular Article 333 of the Civil Code of the Russian Federation. Since the defendant did not dispute the correct application of the norms of Swiss law, it cannot be considered a potential violation of public policy.

Case 1 demonstrates how norms on reducing contractual penalty as a part of substantive law of a country can be applied in arbitration. It also shows that national law systems, other than Russia's, have corresponding or similar norms regarding the right of the court to reduce the amount of contractual penalty and/or liquidated damages that is excessively high. Not

only Switzerland[22], but also South Korea[23], Netherlands[24], Poland[25], South Africa[26] have legal norms corresponding to Article 333 of the Russian Civil Code which an arbitral tribunal can apply when deciding on the amount of penalty to be awarded

3.2. Cases Where an Award Rendered by International Commercial Arbitration Court (hereinafter ICAC) of Russia was set Aside Due to an Exessively High Penalty Amount

3.2.1. Case 2 (Decision of the Arbitrazh Court of the City of Moscow Case #A40-84581/19 of July 24, 2019)

a) Circumstances of the Case

ICAC Russia ruled that due to the untimely payment for delivery of petroleum products by the defendant (a company based in Uzbekistan) the following amounts be awarded in favor of the plaintiff (a company based in the United Arab Emirates): $2,910,239.44 in penalty; $5,854.63 in interest on borrowed funds; $52,441.48 in arbitration fees, and $26,259.74 in costs incurred in relation with arbitration proceedings. The ICAC tribunal refused to reduce the penalty based on its apparent disproportion to the consequences of the breach based of Article 333 of the Civil Code of the Russian Federation, so the defendant challenged the award in Russian domestic court.

b) Court's Motivation and Ruling

The Russian court established that according to the agreement between the parties, the penalty awarded by ICAC was accrued at the rate of 0.05% of the principal debt for each day of delay for the first 15 calendar days, and at the rate of 0.4% of debt for each day of delay for the subsequent period, which amounted to $2,910,239.44. The court deemed that the rate at which the penalty was accrued was excessively high (0.4% for every day of delay), which is many times higher than key rate of the Central Bank of the Russian Federation and therefore not reasonable. Since proportionality of civil liability is one of the elements of public policy[27], the court ruled that the assessment for proportionality of penalty recovered by an arbitration court with the consequences of the breach are within its competence. As a result, the award was set aside entirely based on violation of fundamental principles of Russian law, to be more precise the principle of legality, equality of participants in civil relations, and inadmissibility of abuse of rights. The ruling was upheld in the Court of Cassation.

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[22] Under Article 163(3) Code of Obligations the competent court or arbitral tribunal is required to reduce the amount agreed if and insofar as it turns out to be excessively high.

[23] If the amount of the liquidated damages is excessive, the court can reduce it to a reasonable sum (Article 398(2), Civil Code).

[24] Under Clause 6:94 of the Dutch Civil Code, the court may reduce the contractually agreed penalty at the request of the debtor if it is fair to do so.

[25] According to Civil Code of Poland Art. 484 §2, a contractual penalty may be reduced (a) if the obligation has been substantially performed or (b) if the contractual penalty is grossly excessive.

[26] According to the Conventional Penalties Act of 1962, penalty clauses are enforceable by law, but the court has the power to reduce the compensation.

[27] Clause 29 of the Information Letter of the Presidium of the Supreme Arbitration Court of the Russian Federation dated December 22, 2005 No. 96 "Review of courts' practice of resolving cases on the recognition and enforcement of decisions of foreign courts, on contesting decisions of arbitration courts and on issuing writ of execution for the enforcement of decisions of arbitration courts".

3.2.2. Case 3 (Decision of the Arbitrazh Court of Irkutsk Region Case #A19-26283/2021 of February 28, 2022)

a) Circumstances of the Case

ICAC Russia ruled that based on a lease contract between the claimant and the defendant, the following amounts were awarded in favor of the plaintiff: 1,443,153.77 rubles – principal debt under the contract, 1,498,085.18 rubles – penalty under the contract, 41,223 rubles in claim registration and arbitration fees. The defendant challenged the award in Russian domestic court based on the fact that the penalty amounted to 104% of (e.g., exceeded) the main debt. The defendant believed that the penalty should have been reduced by the court pursue to Article 333 of the Civil Code.

b) Court's Motivation and Ruling

The Russian court established that according to the contract between the parties, the penalty awarded by ICAC was accrued at the rate of 0.05% for each day of delay and amounted to 1,443,153.77 rubles (104% of main debt under the contract). According to the Decree of the Presidium of the Supreme Arbitration Court of Russia (April 23, 2013 No 16497/12), compliance of the penalty awarded by the arbitral tribunal with public policy, the assessment of its proportionality with the consequences of the breach are within the competence of the court. In this dispute, the court found that the penalty accrued significantly exceeds the amount of the principal debt, which cannot be considered proportionate liability for breach of contractual obligations. As a result, the award was partially set aside based on public policy violation and the penalty was not enforced. The court did not specify which fundamental principle was violated by the award, but it should be presumed to be the principle of proportionality.

3.2.3. Analysis

In both cases described above an award rendered by ICAC Russia was challenged in domestic court by the defendant based on the amount of penalty that was recovered in favor of the plaintiff. In both cases the courts ruled that it was within its competence to rule on the issue of whether the penalty was in proportion to the consequences of the contractual breach (although they referred to two different Acts of the Supreme Arbitrazh Court). In both cases the award was set aside (entirely or in part) which meant that the penalty payable to the plaintiff eventually could not be enforced. The cases also illustrate which criteria can be used by the court as a measure of proportionality of a penalty (penalty accrual rate in Case 1 and ratio between the principal debt and the penalty in Case 2). However, it should be noted that neither case offers substantiation as to why the amount of the penalty was not in proportion with the consequences of the breach.

3.3. Cases Where an Award was Enforced Despite the Claims Under Article 333

3.3.1. Case 4 (Decision of the Arbitrazh Court of the City of Moscow Case #A40-192942/19-83-1136 of October 04, 2019)

a) Circumstances of the Case

ICAC Russia ruled that based on a loan agreement between the claimant and the defendant,

the following amount be awarded in favor of the plaintiff: 34,159,526.42 rubles - interest on the loan; 90,639,690.85 rubles – contractual penalty; $1,000,000.00 in damages, and $40,083.00 in registration and arbitration fees.

The defendant challenged the award in Russian court based on violation of public policy; namely, the principles of legality and reasonableness of the decision rendered by the arbitration court, the principle of proportionality of civil liability measures to the consequences of the breach, non-application of mandatory rules of law, and unlawful imposition of additional civil liability on the applicant in the form of recovery of damages, which led to illegal enrichment of the plaintiff at the expense of the defendant.

b) Court's Motivation and Ruling

The court concluded that the defendant did not agree with the application of the rules of law by the arbitration court, as well as the procedural actions of the arbitrators. It is not within the competence of the national court to reassess which legal acts were applied by the arbitral tribunal and whether the relevant legal norms were applied in a correct way when resolving the dispute. Since the defendant's arguments were concerned with the issue of the correct application of law and examination of evidence by the arbitral tribunal, they were overruled by the court. It was also emphasized that the national court is not entitled to review the decision of an arbitral tribunal on merits when considering an application for setting an arbitral award aside[28].

3.3.2. Case 5 (Decision of the Arbitrazh Court of Kostroma Region Case #A31-7930/2018 of August 31, 2018)

a) Circumstances of the Case

The Arbitration Center of the National Chamber of Entrepreneurs of the Republic of Kazakhstan "Atameken" ruled that based on the contract for sales of pharmaceutical products the following funds were awarded in favor of the plaintiff: 73,966,197 rubles in penalty, 11,152.42 rubles in claim registration fees, 1,109,492.96 rubles in arbitration fee, 3,458,334.64 rubles in the cost of the services of a court representative. The plaintiff applied for enforcement of the arbitral award in Russian court. The defendant raised objections against the enforcement of the award based on the lack of jurisdiction of the Arbitration Center over the dispute, as well as on violation of the principle of proportionality of measures of civil liability, which is a fundamental principle of Russian law, and which also prevents the recognition and enforcement of the arbitral award on the territory of the Russian Federation.

b) Court's Motivation and Ruling

The court ruled that no violation was committed by the arbitration court. When resolving the dispute, the arbitral tribunal applied the law of the Russian Federation. During arbitration,

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[28] Paragraph 12 of the Information Letter of the Presidium of the Supreme Arbitrazh Court of the Russian Federation dated December 22, 2005 No. 96 "Review of courts' practice of resolving of cases on the recognition and enforcement of decisions of foreign courts, on contesting decisions of arbitration courts and on issuing writ of execution for the enforcement of decisions of arbitration courts".

the defendant filed a petition stating that the penalty should be reduced (Article 333 of the Civil Code of the Russian Federation should be implemented by the court). Said petition received legal assessment by the arbitral tribunal, and the motives for rejecting the petition were reflected in the text of the award, thus the debtor's right to apply for a reduction in the penalty was not infringed upon. The objections of the defendant as to why his petition was declined cannot prevent the court from recognizing and enforcing the award because it would mean review on merits of the award. As a result, the petition for recognition and enforcement of the award was granted.

3.3.3. Analysis

From the text of the courts' decisions, it is difficult to judge whether the penalty was disproportionately high because they are silent on the amount of the principal debt or the penalty accrual rate. However, what separates Cases 4 and 5 from Cases 2 and 3 is the court's ruling regarding whether or not it was in its competence to review the award based on the defendant's argument that the penalty should or should have been reduced. The Russian domestic courts have the right to set an arbitral award aside or to refuse to recognize and enforce an arbitral award in case where the public policy of the state is violated. The public policy exception is one of the grounds that can be invoked by the court even when it is not requested by one of the parties to the dispute. Since earlier we established that there is an acknowledged link between the proportionality of civil liability and the public policy of the Russian state, the courts could have used the public policy exception to set aside an award or refuse to recognize it, however, they opted out of doing so. In Case 4 the court found that the issue of whether the penalty had to be reduced or not is an issue of the application of substantive law, and therefore is outside the domestic court's jurisdiction. In Case 5 the issue of reducing the penalty arose during arbitration and the arbitral tribunal did not find that there were substantial grounds for reducing the penalty. Thus, the court found that revisiting the issue would qualify as reviewing the dispute on merits.

There is a certain trend present in Russian domestic commercial arbitration: if a claim to reduce the penalty under Article 333 was not made during arbitration the court will not recognize such claim as a substantial ground for refusing to enforce the award or to set an award aside. There have been a number of cases where a claim under Article 333 is declined by the court where the defendant tried to use it as an argument against having an award enforced[29]. Since such argument was declined under the same circumstances as in Case 4, the trend can be applied to international arbitration as well.

[29] ICAC Russia ruled that the following amount are awarded in favor of the plaintiff: 2,400,000.00 rubles (principal debt), 117,916.49 rubles (interest on the loan), 2,400,000 rubles (interest for the use of the loan, accrued at a rate of 6% per annum on the actual debt from the loan for the period from 08/14/2021 to the day of actual performance); 2 517,916.49 rubles (a penalty accrued in the amount of 0.3% per day on the actual debt of the debt amount for the period from 08/14/2021 to the day of actual performance); 40,884.00 rubles (registration and arbitration fees). The plaintiff applied for enforcement of an arbitral award to the public court. The defendant objected against enforcement of the award: in her opinion the arbitral tribunal was under obligation to apply Article 333 (reduction of unproportionally high penalty), but did not do so. The Court disagreed: considering that the defendant did not file a petition to reduce the amount of penalties during arbitration, the arbitral tribunal had no grounds for applying Art. 333 of the Civil Code of the Russian Federation.

4. Implications and Recommendations for Practitioners in South Korea

As it was stated in the introductory section of this article, the primary goal of this research is to discern and formulate practical implications of the principle of proportionality of contractual penalty when applied by the Russian domestic courts in the process of challenging and/or enforcing arbitral awards.

4.1. The Stage of Drafting a Contract

A contract that is governed by Russian law can include a penalty clause that is enforceable in court. A penalty can be imposed for breaching a primary obligation under the contract such as delay in payment, delay in delivery, as well as for secondary obligations such as providing documentation related to the contract etc. It is important to remember that the general rule is that damages can be awarded in the amount that is not covered by the contractual penalty, and in order to recover the full amount of damages in excess over the contractual penalty, such condition must be explicitly stipulated in the contract[30].

The penalty amount can be defined as a sum of money or it can be accrued at a percentage for every day, month, year until the obligation is performed, or until the breach is mended (in case of a continuous breach of contract). Although pursuant to the principle of contractual freedom parties are free to define the amount of contractual penalty, in order for a penalty clause to be enforced by a court without penalty reduction it is recommended to adhere to the following guidelines: at the stage of drafting the contract the parties can take into account such factors as the cost of goods under the contract, the duration of breach, whether a breach can incur damages or affect other contractual obligations of a party. The general rule for penalty accrual is double the key rate[31] of the Bank of Russia that was in effect at the moment the breach was committed, but it can never be reduced below the key rate mark. A penalty that is unjustifiably high can be included in the contract as a way of dissuading parties from breaching their obligations, however, if a dispute is submitted to a court or arbitral tribunal, such penalty will most probably be brought down to double the key rate or the key rate of the Bank of Russia existing at the moment of the breach.

4.2. The Stage of Arbitration

After a dispute is submitted to arbitration, there are certain steps that can be followed in order to successfully reduce an excessively high penalty. First and foremost, there has to be a petition filed by the defendant asking the tribunal to assess the proportionality of the penalty under Article 333. The petition must be substantiated as to why the amount of penalty and the consequences of the breach are not in proportion with each other, at the same time there are certain arguments that a party in breach is not allowed to use as evidence. They include financial difficulties, debts to other creditors, seizure of money or other property of the defendant, lack of public funding, non-fulfillment of obligations by counterparties, voluntary

[30] Article 394 of the Civil Code of the Russian Federation.

[31] The official sources of information on average bank interest rates on deposits of individuals, as well as on the key rate of the Bank of Russia, are the official website of the Bank of Russia and the official publication of the Bank of Russia - Bulletin of the Bank of Russia.

repayment of the debt in full or in part on the day, dispute resolution, performance by the defendant of socially significant functions, the obligation of the debtor to pay interest for the use of cash[32]. At the same time, the factors that will be more beneficial to place emphasis on are the ratio of the amounts of the penalty and the principal debt, duration of breach, the ratio of the penalty accrual rate to key rate of the Bank of Russia, and the creditor's lack of good faith.

4.3. The Stage of Challenging an Arbitral Award and/or Recognition and Enforcement of an Arbitral Award

From case analysis that was conducted in Chapter II it can be concluded that there are two conflicting trends when it comes to the application of Article 333 by Russian domestic courts regarding arbitral awards: on one hand, it is possible to set aside an arbitral award through public policy defense by claiming that the penalty awarded to the plaintiff does not meet the requirements of proportionality, and on the other hand, such claim can be overruled based on the view that reducing a penalty is an issue of the substantive law that the arbitral tribunal applied and lies outside the competence of domestic court. Depending on the desirable outcome, the following arguments can support the corresponding position. For the defendant who is seeking to challenge an award and/or raise objection against its recognition and enforcement: providing evidence of disproportionately high penalty, establishing the connection between the principle of proportionality of civil liability and the public policy of the state[33], and emphasizing that the claim for penalty reduction was brought at the stage of arbitration proceedings. For the plaintiff who is seeking to have an award recognized and enforced or raising objections against setting an award aside: in cases where the issue of reducing the penalty was raised during arbitration, emphasize that said issue received the necessary assessment by arbitral tribunal, and that it is beyond the domestic courts' competence to review the issues of application of substantive law. In cases where the issue of reducing the penalty was not raised during arbitration, it is recommended to refer to the decisions of the courts that expressed the opinion that if a claim under Article 333 was not brought during arbitration, it cannot serve as a ground for setting aside or refusing to recognize an award.

5. Conclusion

The principle of proportionality of civil liability is one of fundamental principles of the Russian legal system. One of the ways it manifests itself in contract law is through the requirement that a contractual penalty must be proportionate to the consequences of the breach, and in cases where this requirement is not met, the courts have the right to reduce the penalty to a reasonable amount (Article 333 of the Civil Code of Russia). Being a fundamental legal principle that is present in various branches of law, the principle of proportionality is treated as an element of public policy of the Russian state. For this reason, a dispropro-

[32] Resolution of the Plenum of the Supreme Court of the Russian Federation of March 24, 2016 N 7 "On the application by the courts of certain provisions of the Civil Code of the Russian Federation on liability for breach of obligations" with changes and additions from February 7, 2017, June 22, 2021.

[33] Specifically by referencing Decree of the Plenum of the Supreme Court of the Russian Federation of March 24, 2016 No. 7.

tionately high contractual penalty can often be grounds for setting an award aside or for refusing to enforce it by the court. This article has explored the nature of the principle of proportionality and how it is regulated under current Russian law. The analysis of recent court cases shows that there are conflicting trends when it comes to application of Article 333 by Russian domestic courts. Correspondent recommendations for legal practitioners were made based on the current legislation and recent judicial practice analysis.

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