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International Arbitration In London From The Perspective Of A Civil Law Lawyer: Rome I Regulation And Contractual Penalties

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International arbitration takes a great pride in being flexible, adjustable and thus very responsive to the needs of the parties involved. Indeed, in terms of international arbitration imagination has virtually no limits – nothing really prevents parties to an arbitration agreement from agreeing on an arbitration pursuant to the UNCITRAL Arbitration Rules, in the Spanish language, administered by SIAC, seated in Dubai, with Australian governing law or to opt not to include some of the features into the "arbitration package". Of course this example is largely exaggerated and often times what appears to be a little creative may be justified for good reasons. Nevertheless, the unusual content of such an arbitration package may not only be impractical but also unpredictable as to the legal consequences. Such an arbitration then requires extra attention and vigilance on the part of the legal counsels.

We have recently encountered an interesting arbitration in this respect. This London-seated LCIA arbitration (London seat was chosen by the parties in the arbitration clause) arose over a complex dispute involving a cross-border petroleum transaction. A petroleum trader, a Czech entity, had agreed to purchase a bulk of petroleum products from another, Russian entity, to be delivered over a certain period of time. The transaction fell into the time frame when economic sanctions were imposed upon Russia by the EU, as a result of which the transaction was not carried out. The main issue subject to the arbitration proceedings that followed was the extent of the alleged damages.

The contract did not contain an agreement on a key provision, namely the law applicable to the contract. We all know very well, how important the inclusion of a choice of law clause in the contract is, at least it avoids a lot of uncertainty down the road. There are however, situations, when the choice of law is missing and one has to resort to conflict of laws rules, especially if the parties are unable to agree on the applicable law.

The LCIA Rules as well as the other arbitration rules are of little help, stating in Article 22.3 that the Arbitral Tribunal shall apply the law which it considers appropriate. In ordinary circumstances, if the prerequisites for the application of the CISG are met, the Tribunal should apply the CISG. The damages provisions of the CISG are not, however, very detailed. Art. 7(2) of the CISG suggests that any matters which are not expressly settled in the CISG are to be settled in conformity with the general principles on which the CISG is based or, in the absence of such principles, in conformity with the law applicable by virtue of the rules of private international law.

Here comes the tricky part. Within the EU, the conflict of law rules that determine the law applicable to contracts are harmonized by the Rome I Regulation. At the same time, Rome I excludes arbitration agreements from its scope. There is thus an ongoing discussion on whether arbitrators are under an obligation to apply the Rome I Regulation. On the one hand, it has been argued that the exclusion of the arbitration agreement in Rome I (Art. 1 para 2 e)) should be extended to arbitration itself since the Regulation is designed to complement Brussels I, which excludes arbitration from its scope. As a matter of fact, the recitals of Rome I refer only to national courts and are otherwise silent with regard to arbitral tribunals. This posture, therefore, comes to a conclusion that arbitrators are not required to apply Rome I and Rome I is thus only one set of conflict of laws rules among others to determine the most suitable applicable law in the absence of party choice. On the other hand, others argue that the term "court" used by Rome I must be broadly interpreted and it refers to any forum applying substantive law in adversary proceedings, arbitration included.

Actually, whether Rome I applies to a contract in arbitration proceedings may be a very relevant question, especially when a contract is concluded between non-EU parties. It is because Rome I has universal character (cf. Art. 2 of Rome I and no personal/territorial scope limitation in the text of Rome I, unlike Brussels I) which implies that Rome I is applicable without any additional link to the EU, be it the parties or the place of execution of the contract. Hence, the Regulation would even apply in litigation within the EU to a contract concluded and executed in a third country between two non-EU parties which, for any conceivable reason, come to a member state to litigate. If Rome I is to apply in arbitration in the way it does in the courts of member states, any agreement of the parties on the seat of arbitration within the EU would also determine the set of conflict of law rules and inherently also the governing law of the contract. Non-EU parties, by leaving the choice of law clause out of their contract (and thus relying on the private international law rules of either party's state) but choosing an arbitral seat within the EU, for example, for enforcement purposes, may not always realize that by virtue of their agreement on a seat they build a kind of governing law clause into their contract (which may provide for different applicable law than the law determined by the private international law rules of either party's state).

In our case, the arbitral tribunal not only has not contradicted the claimant's position which has been to apply Rome I, the tribunal has even indicated that the application of Rome I is mandatory. This case is thus an interesting contribution towards the debate. However, it was not the only interesting issue arising in this arbitration.

When concluding a lengthy international contract, it is nearly impossible to anticipate all the legal consequences that may arise out of the contractual provisions in the later arbitral proceedings. What one should pay special attention to, however, are the provisions on damages. Despite the confidence brought by having some civil law system apply to the contract, appropriate considerations should be taken with regard to the composition of a tribunal. It is not uncommon in Europe that the tribunal consists of one English arbitrator, although one may encounter that situation in London more often than anywhere else. A civil law lawyer should note that English law has a particular interest in non-enforcement of the contractual penalties and, as our case demonstrates, English arbitrators are willing to (at least) consider application of the English rule against penalty clauses in contracts not only as a consequence of a choice of English law but also as a matter of public policy in cases, where another law is chosen.

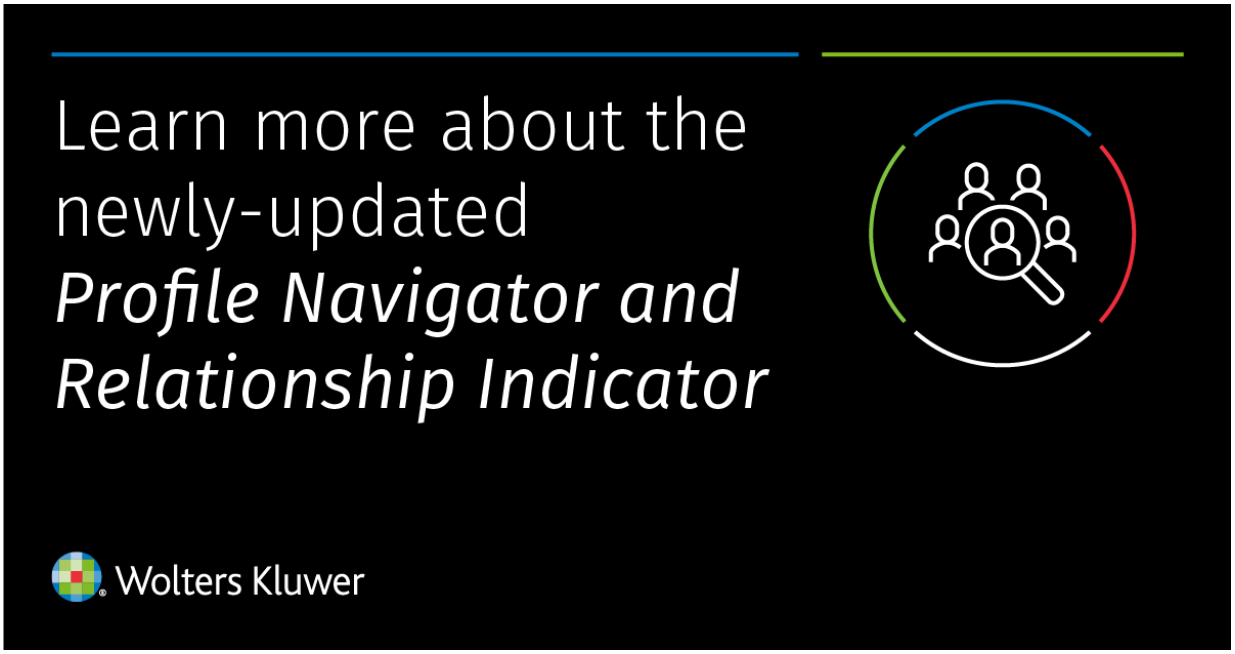
It shall be noted that a London seat by itself in arbitration agreement will often not be sufficient to render a contractual penalty unenforceable. In fact, English doctrine limits applicability of the

public policy exception to a very limited pool of cases. It has been applied to refuse to enforce a contract only under two circumstances: (i) if it would infringe fundamental English ideas of justice and morality (only in exceptional cases such as slavery) and (ii) if it tends to injure the public interest in a way which an English invalidating rule is designed to prevent. The latter then requires that the contract has relevant connections with England (other than the connection by reason of the forum where the dispute is held). Therefore, if one handles a dispute with non-English parties, where the facts are not in any way linked to England, there is ground for concern.

It is also appropriate to mention that not all contractual penalty clauses are unenforceable under English law. What is often labeled as a contractual penalty clause in civil law systems may include both a penalty clause, which is unenforceable, and a liquidated damages clause, which is permitted subject to certain conditions. In addition, recent development such as the English High Court's judgement in *Pencil Hill Limited v US Citta di Palermo S.p.A.* suggests that contractual penalty-based awards may in fact be enforceable in England if moderated by an arbitral tribunal. The significance of such an approach is highlighted by the fact that moderation tools are inherent in most civil law systems.

Our case fell within the category of cases with no link to England. When drafting the contract, the parties simply chose London as a forum to arbitrate their contractual disputes. The arbitrator acknowledged that fact by ignoring the public policy exception and through enforcement of the contractual penalty under the Russian law.

As is common in international arbitration cases, what may have seemed at first glance like a pretty straightforward breach-of-contract/change-in-circumstances case involving the law of one country, revealed further reaching questions relating to the governing law of the contract and the enforcement of the contractual penalty. In the end, four different sets of conflict of law rules and three different legal systems were considered as potentially applicable to the contract. In contrast, and quite surprisingly, the breach-of-contract/change-in-circumstances has not been subject of greater controversy.



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