

## Arbitral Awards Based on Penalty Clauses: Enforceable?

***A recent English High Court decision suggests that some such awards may be enforceable notwithstanding the rule against penalties.***

In *Pencil Hill Limited v US Citta di Palermo S.p.A.*, the English High Court enforced an arbitral award that was based on a penalty clause in an agreement. The award was issued by the Court of Arbitration for Sport (the CAS) in Switzerland. The High Court's decision is of interest because penalties are not normally enforceable under English law. This *Client Alert* considers the ramifications of the decision on penalties in the context of international arbitration.

### The English aversion to penalties

Under English law, penalties are not enforceable. This rule, which is typically justified on public policy grounds, is an exception to the general principle that a contract should be enforced in accordance with its terms.

The Supreme Court considered the issue of penalty clauses last year in *Cavendish Square Holding BV v El Makdessi; ParkingEye Limited v Beavis* [2015] UKSC 67. In their joint speech, Lord Neuberger and Lord Sumption characterised a penalty as “a secondary obligation which imposes a detriment on the contract-breaker out of all proportion to any legitimate interest of the innocent party in the enforcement of the primary obligation.”

### Footballers and penalties – a controversial topic

Palermo and Pencil Hill entered into written contracts relating to the sale of financial rights deriving from certain registration rights of a footballer, Paulo Dybala. Under one of the contracts, which was governed by Swiss law, Palermo agreed to pay Pencil Hill a sum of €6.72 million in two equal instalments. The contract further provided that should Palermo fail to pay, all remaining amounts would become due and, as a penalty, Palermo would be required to pay double the amount outstanding. Palermo failed to pay any of the agreed sum.

In arbitration proceedings before the CAS in Switzerland, Pencil Hill claimed €6.72 million on the basis of the penalty provision. In its award, the CAS directed Palermo to pay Pencil Hill €1.68 million representing 25% of the penalty claimed. Following Palermo's unsuccessful challenge to the supervising court in Switzerland, Pencil Hill sought to enforce the CAS' award in the UK.

Section 103 of the Arbitration Act 1996 obligates English courts to enforce an arbitral award pursuant to the New York Convention, subject to certain exceptions. One such exception is that “*it would be contrary to public policy to recognise or enforce the award.*”

In the High Court, Judge Bird ruled in favour of enforcement for two reasons:

- First, the circumstances in which English courts may refuse enforcement under the New York Convention of a foreign arbitral award are narrow, for example, where a universal principle of morality needs to be protected or where there is a risk of injury to the public good. The judge was satisfied that the *“the important public policy against enforcement of penalty clauses [was] not sufficient to permit [him] to refuse enforcement”* in the instant case. The judge also noted the importance of the parties’ choice of Swiss law to govern the contract, which empowered courts to interfere with a penalty by reducing it. Accordingly, *“the public policy of upholding international arbitral awards ... outweigh[ed] the public policy of refusing to enforce penalty clauses. The scales are tipped heavily in favour of enforcement.”*
- Second, the effect of the CAS’ reduction under Swiss law of the amount claimed changed the nature of the obligation from penal to non-penal. According to the judge, *“[t]he position then is not that Swiss law upheld a penalty, rather it is that Swiss law removed a penalty and replaced it with an obligation to pay a sum it regarded ... as neither exorbitant nor unconscionable.”* He added that *“[a]s this Court is ... not adjudicating upon the underlying contract, it is easy to see that the decision of the curial court – the court chosen by the parties applying the law chosen by the parties – should be respected.”*

## Post-match analysis

At first glance, the decision suggests that English courts might enforce an arbitral award based on a penalty clause where such clause is permitted by the governing law of the agreement in which it is contained. This makes sense given the courts’ historically robust approach towards enforcing arbitral awards and, more generally, party autonomy and the preservation of the sanctity of bargains struck between parties.

However, a few words of caution are necessary:

- First, the High Court considered the enforceability of penalties in the context of an award pursuant to the New York Convention where the penalty clause was governed by foreign law. The decision does not purport to alter the application of the rule against penalties where, for example, English law governs the contract.
- Second, the permissibility of penalties varies from jurisdiction to jurisdiction.
- Third, one may question whether the High Court really upheld a *“penalty”* at all. As Judge Bird pointed out, the CAS’ award reduced the amount payable so as to remove the penal effect of the clause. Viewed in this light, the High Court’s decision appears to be in line with the rule against penalties.

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