THE NOTION OF GROSSLY EXCESSIVE STIPULATED PAYMENT IN THE POLISH CIVIL CODE

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Abstract: The article concerns criteria for reduction of contractual penalties (liquidated damages) in Polish law. The first part of the article discusses general conditions for contractual penalty's reduction. The second part regards specific criteria used in assessing whether a contractual penalty should be considered "grossly excessive" or not. Each criterion is accompanied with a commentary containing indication of basic advantages and defects of a given criterion. Analysis of criteria is supplemented with examples of the recent Supreme Court's judgments. The article wraps up with a proposition of a criterion that seems to be the most appropriate for assessing contractual penalties in terms of their excessiveness.

Keywords: contractual penalty, reduction of stipulated damages, grossly excessive penalty, Supreme Court's judgments

1 The introduction

Stipulated payment has been regulated in Articles 483- 484 of the Polish Civil Code. By and large, an introduction of a penalty clause allows for a quite prompt enforcement of claims due to the creditor from the debtor in the event of non-performance or improper performance of an obligation. Under Article 484 § 1 of the Civil Code, contractual damages are due in the stipulated amount irrespective of the value of the actual loss.

Even so, clarity of this system is undermined by the existence of Article 484 § 2 of the Civil Code, enabling judges to interfere in a contractual relationship and reduce an amount of stipulated damages. Due to relatively lenient conditions for pursuing contractual penalties, having this kind of "safety valve" seems to be necessary though. There is a risk that a debtor, unaware of consequences of a stipulated penalty may agree to pay the amount that many times exceeds the level of legitimate creditor's interests. Nonetheless, the judicial discretion is quite often abused and *prima facie* quite straightforward proceeding turns into a full civil remedies proceeding, in which the court decides on its own what the amount of damages is due to the creditor. Moreover, even if the decision itself concerning reduction of the stipulated payment is right, criteria used by courts are often so vague that any predictability of a final judgment becomes illusory. Many wrong practices developed regarding criteria used for contractual penalty's reduction. Therefore, it is worth a while to put all collected data in order and organize it all in a systematic way.

2. Reduction of stipulated payment

As rightly indicated Janusz Szwaja, the reduction of contractual penalty means "abridgement of the amount of the contractual penalty due to the creditor, as a result of a request made by the debtor to the relevant court." *Ratio legis* of this possibility shall be sought in the need to protect the debtor, who agreed to stipulate contractual penalty in the excessive amount (extending legitimate creditor's interests).

Despite the absence of express provision to that effect, it is quite clear that Article 484 § 2 of the Civil Code (providing for the possibility of reducing excessive payments), has the character of the peremptory norm (*ius cogens, compelling law*). The aim of this norm is to safeguard interests of the debtor. Introduction of clauses which have the effect of preventing one or both of the parties from demanding penalty's reduction have no legal effect. It is also worth noting that the „reduction of repression" is not one of the aims of this institution, neither the desire to strike the right balance between conflicting interests of the parties (so that those who suffered were not unjustly enriched at the expense of debtors – in line with the latin dictum: *„ne quis ex damno suo lucrum faciat*").

Article 484 § 2 of the Civil Code provides for only two grounds which allow a stipulated penalty to be reduced. It is possible:

(i) "if the obligation has been performed in the significant part", and

(ii) where the stipulated penalty is grossly overstated (*„grossly excessive*").

In comparison to the Code of Obligations (1934), the Civil Code does not mention any other examples constituting additional grounds for reduction of stipulated payments, such as "no injury" or "minor loss."

2.1 Performance of the significant part of the obligation

The first basis for reducing stipulated payments is quite obvious ("performance of the obligation in the significant part"). In order to determine whether the obligation has been performed in the significant part Article 354 § 1 of the Civil Code should be applied. The starting point for any further analysis is always the question whether the creditor has derived any benefit (in any way) from a partial performance of the obligation.

In the decision of the Supreme Court dated March 25, 2011 the Supreme Court held, that "an admissibility of the reduction in stipulated damages by reason of the performance of the obligation in the greater part is based on the assumption that the partial performance of the obligation satisfies the legitimate creditor's interest". Insofar as this assumption cannot be met the reduction in stipulated damages cannot take place. The reduction does not deserve to be admitted in particular where the partial performance of the obligation has for the creditor no relevance whatsoever. If the partial performance has no relevance for the creditor, then cannot be said that the obligation has been performed "in the significant part".

If the partial performance was consistent with the creditor's interests, then the next step is to consider whether it was "the performance in the significant part." The performance of the obligation in the significant part means that the creditor's interests are satisfied in the essential part. It is not right to reduce stipulated damages if any of the creditor's interests has been satisfied. Furthermore, it is possible to reduce stipulated payments on this basis only if they were stipulated "wide". If the contractual penalty was stipulated in proportion to the number of violations, or depending on the degree of debtor's default, or the weight of a specific breach, then the reduction in stipulated damages on this basis is incorrect.

There is also an opinion that it is wrong to reduce the amount of stipulated damages on account of "performance of the obligation in the significant part" where a contractual penalty has been reserved for delay in performing the whole obligation. Nonetheless, the Supreme Court in its decision dated September 21, 2007 held that: "as a rule, the reduction in stipulated damages reserved for delay in performance of the obligation is permissible also because of the performance of the obligation in the significant part." It seems that this decision is wrong. In such a case, the contractual penalty should be reduced because it is "grossly excessive" not because the obligation has been performed in the significant part.

2.2 Gross excessiveness of contractual damages

The second basis for reduction is much more controversial. The term "gross excessiveness" is vague, therefore it allows for quite broad interpretation. The Supreme Court in its decision dated May 12, 2006 stated that: "Article 484 § 2 of the Civil Code does not provide for any criteria for reducing contractual penalties (...) therefore the catalogues of possible criteria is open-ended and belongs to the discretion of the judge; likewise a hierarchy of those criteria. (...)." According to the Supreme Court, different criteria may be taken into account. It is possible to take into account criteria having absolute values (e.g. an amount of stipulated damages in itself), relative criteria (assessment of the amount of stipulated damages relative to other elements, such as,

total value of consideration, the amount of loss suffered, the amount of damages due to the creditor under general rules of civil liability), or even other criteria of non-pecuniary nature (what is right, what equity demands in particular circumstances etc.).”

However, an important restriction stems from the fact that not every overstatement of contractual payments entitles debtors to their reduction. Only those contractual penalties which are “grossly excessive” are allowed to be reduced. In particular, the contractual damages are liable to be reduced if they are stipulated in such an amount, that the excessiveness of the penalty is obvious. According to K. Zagrobelny: "the debtor may request the court to reduce the contractual penalty only if the disproportion of stipulated damages is substantial and visible to anyone.” The judge should not even start to examine whether the contractual penalty is (in given circumstances) "adequate", "accurate", or "right", if in the first place a potential disparity is not “excessive”.

3. Assessment’s criteria

The most important reason for existing discrepancies in judicial decisions is the application of different criteria in assessing similar factual situations. This state of affairs is obviously undesired. The term “gross excessiveness” should be construed and applied in consistent way. Therefore, there is a need to develop and establish coherent criteria of assessment whether a given contractual penalty should be deemed “excessive” or not. Janusz Szwaja made a careful study of criteria that may be of relevance for assessing "gross excessiveness” of contractual payments. With the aid of this analysis it is worth examining the following criteria:

3.1. Absolute value of stipulated damages

The criterion is inappropriate because it is not possible to identify any level of penalty which is “right” or “reasonable”. It is impossible to recognize a particular penalty as excessive in isolation from other factors. It is wrong to seek any indicator of adequacy in judicial precedents or any particular practice (e.g. average amount of penalties stipulated on the market). Nonetheless, the Supreme Court does not exclude such possibility. In the decision dated January 26, 2011, the Supreme Court decided that: "the court - using Article 484 § 2 of the Civil Code - should consider all circumstances of the given case. It shall not limit its assessment to sole comparison of stipulated damages to the rates commonly used for reserving such penalties on the market."

3.2. Relation of stipulated damages to the value of performance

This criterion does not seem to be correct either. It is incompatible with the function of contractual penalty. Stipulated payment replaces damages and not the debtor’s performance. It is worth noting that losses incurred by the creditor as a result of debtor’s default can often exceed the value of the performance. Even so, the Supreme Court does not mind using this criterion. For instance, in a decision dated January 16, 2009 the Supreme Court held that: "the Court of Appeal correctly took into account other criteria of a quantitative nature, including (...), the relation of stipulated penalties to the total value of mortgage upon acquired real estates, and the total prices paid for those properties." It should be noted that the debtor's obligation was to delete mortgages from the Land and Mortgage Register.

Using this criterion, even auxiliary, is quite 'tempting', because often the value of performance (or consideration) is only information which can be relatively easily established by the court. This does not mean that this is a correct practice. The value of the performance should not have any major impact on the amount of stipulated damages.

3.3. Relation of stipulated damages to legitimate creditor’s interests

It is criticized because it is based on subjective criteria, and pays no attention to repressive function of the contractual penalty. This criterion is approved by, among others, Jacek Jastrzebski. In this context it is worth quoting the decision of the Supreme Court dated April 14, 2005, in which the Supreme Court held that: "besides easily calculable the loss suffered (…) negative consequences may also include the loss of confidence of business cooperators in connection with the failure to perform, and consequently, the loss of market position.”

3.4. Relation of stipulated damages to damages suffered

This is the criterion that was explicitly mentioned in Article 85 of the Code of Obligations (1934). It is endorsed by many legal scholars, among others, Zbigniew Radwański and Andrzej Rembieliński , and the recent decisions of the Supreme Court, inter alia, the judgment of June 20, 2008, in which the Supreme Court held that: "In the case of reduction of stipulated penalty by reason of its excessiveness, the main criterion should be the relation between the amount of stipulated damages and the amount of damages incurred by the creditor.”

According to Janusz Szwaja, the stipulated payment replaces statutory remedies, not all damages suffered. Therefore, this criterion is unsound. It also should be added that such an approach leads to numerous complications. It is not clear which damages should be taken into account, only damages to the property or maybe personal injuries as well. It also requires the examination of damages (their amount), while the contractual penalty is due regardless of the amount of the actual loss. Finally, this approach does not allow for taking into account the contribution of an aggrieved party to damage arising or increasing .

3.5. Relation of stipulated damages to statutory remedies

This criterion was endorsed by Janusz. Szwaja. He believed that it is the most appropriate and the most flexible of all contemplated criteria. It allows for taking into account other factors than just the amount of loss suffered. This criterion is advocated by other scholars as well, among others, by Joanna Dąbrowa, Mirosław Bączyk and Krzysztof Zagrobelny.

In the judgment of September 28, 2010, the Court of Appeal in Katowice found this criterion to be the most important: "the essential criterion for reducing stipulated damages by reason of their excessiveness is the relation of the amount of stipulated damages to the amount of remedies due to the creditor under general rules of civil liability." However, it is problematic whether it is correct to compare the amount of contractual damages to the amount of statutory remedies, in all those cases where the contractual penalty is supposed to compensate not only for damages compensated on the basis of the general rules of civil liability but also for other damages.

3.6. Conciliatory position

There is also the conciliatory position available. It is represented by, among others, Tadeusz Wiśniewski, who thinks that the “gross excessiveness” should be assessed on the basis of variety of factors, such as the amount of damages suffered, the level of debtor's fault, the value of the principal obligation, the contribution of the aggrieved party to the amount of loss etc.

In this context it is worth noting the position presented by the Supreme Court in the decision dated November 30, 2006, where the Supreme Court held, that the legislator introduced to Article 484 § 2 of the Civil Code a vague term of “gross excessiveness” on purpose. The aim of this was to provide the appropriate level of flexibility. The reduction of stipulated damages is subject to the judge's discretion, who should always take into account all specific circumstances of the given case. Besides, the judge should also pay heed to the basic functions of the contractual penalty, such as, stimulation to the proper performance of

assumed obligations, dissuasion from breaching the agreement, and compensation for incurred damages.

This approach is one of the most common. However, it has a one major drawback - the final decision of the court is for parties unknown and hard to predict. It seems that the mere degree of excessiveness - "gross" provides sufficient flexibility and there is no need to increase it by using quite arbitrary criteria.

4. Conclusions

Stipulation of the contractual payment can serve as an instrument of extending the scope of 'relevant damages' (damages which are due from the debtor as a result of the breach of contract). In consequence of introduction of a penalty clause into an agreement, the debtor may be obliged to compensate the creditor not only for all property damages but personal ones as well. Given that, comparing the amount of stipulated damages to the creditor's interest means de facto the same as comparing it to the amount of damages suffered. In this sense approach presented in point 3.3 and 3.4 are consistent.
As regards the criterion described in point 3.5, it is clear that the parties stipulating contractual payment regulate the extent of relevant damages in a distinct and autonomous way. Therefore, there is no reason to compare the amount of stipulated damages to the amount of statutory remedies. However, it should be noted that in many cases (if no damage other than compensated within the limits of Article 361 of the Civil Code is to be remedied) this criterion will be consistent with the criteria mentioned in points 3.3 and 3.4 as well.

Janusz Szwaja rejects the criterion of legitimate creditor's interest (point 3.3) due to the fact that it makes the assessment dependent on subjective criteria, specific to particular features of the creditor. According to Jacek Jastrzebski: "Subjective nature of the creditor's interest does not preclude protecting it by stipulation of the contractual penalty (...)." All in all, through stipulation of the contractual penalty, the parties autonomously estimate the value of creditor's interest. The estimation is made by both parties, and as long as the debtor knows exactly what it is obliged to do, it should not be worried about the meaning of the proper performance to the creditor.

It seems that the creditor's interest criterion is the most appropriate. However, one important reservation is required. The assessment of "gross excessiveness" of stipulated damages should be based on a comparison of the amount of stipulated damages to the value of the creditor's interest, which was taken into consideration by the parties at the time of the agreement's conclusion. For the purposes of reduction of stipulated damages certain objective values are necessary. For the assessment of "gross excessiveness" only the creditor's interests that were foreseeable at the time of the agreement's conclusion should be of any relevance. The loss actually sustained, or creditor's interests actually affected should not influence the assessment of the contractual payment in terms of its "gross excessiveness". It is necessary to caveat that this is only a postulate *de lege ferenda*. As the above cited Supreme Court's decisions demonstrate, at present, none of the criteria contemplated herein is considered to be more legitimate than others.

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