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January 2012

## Penalty Clauses and the CISG

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# ARTICLES

## PENALTY CLAUSES AND THE CISG

*Jack Graves\**

### ABSTRACT

Commercial agreements often provide for “fixed sums” payable upon a specified breach. Such agreements are generally enforced in civil law jurisdictions. In contrast, the common law distinguishes between “liquidated damages” and “penalty” clauses, enforcing the former, while invalidating the latter as a penalty. The UN Convention on Contracts for the International Sale of Goods (CISG) does not directly address the payment of “fixed sums” as damages, and the validity of “penalty” clauses has, traditionally, been relegated to otherwise applicable domestic national law under CISG Article 4. This traditional orthodoxy has recently been challenged—suggesting that the fate of a penalty clause should be determined by reference to the general principles of the CISG and that such a clause should generally be enforced. The validity of fixed sums, as penalties, is currently under consideration by the CISG Advisory Council, so further exploration of the issue would seem particularly timely. This article examines the basis for the traditional view, along with two distinct challenges to that view—ultimately concluding that these challenges fail to support their respective solutions to the issue and suggesting the continuing vitality of the traditional view.

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## 1. INTRODUCTION

Commercial agreements often provide for “fixed sums” payable upon a specified breach. Such provisions may serve a broad array of specific purposes.<sup>1</sup> However, most of these purposes will focus upon one of three general objectives: (1) good faith estimation of damages likely to be caused by the specified breach; (2) coercion of performance by requiring, in the event of non-performance, the payment of a fixed sum that exceeds any reasonable estimate of actual damages; or (3) limitation of damages by fixing a sum less than any reasonable estimate of actual damages.<sup>2</sup> This article will focus on the distinction between the first two objectives—estimation of actual damages, as contrasted with coercion of performance through the use of a penalty for non-performance.<sup>3</sup> The former is generally enforceable in commercial agreements in all legal systems.<sup>4</sup> However, the latter has historically been deemed invalid under the common law based on its coercive nature and punitive effect when enforced.<sup>5</sup> In the discussion that follows, and consistent with common practice,<sup>6</sup> I will use the term “liquidated damages” clause to refer to a “fixed sum” intended as a good faith estimate of actual damages, while I will use the term “penalty” clause to refer to a punitive “fixed sum” intended to deter breach beyond the effect provided by the standard monetary “expectation” remedy for breach.

The United Nations Convention on Contracts for the International Sale of Goods (the “CISG”) does not expressly address fixed sums in either form. While CISG Article 6 grants the parties the autonomy to agree upon the payment of fixed sums in the event of breach, CISG Article 4 relegates questions of the “validity” of such an agreement to domestic national law.<sup>7</sup> Thus, the traditional view provides that the “validity” of a clause providing for

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1. See, e.g., E. ALLAN FARNSWORTH, *CONTRACTS* § 12.18, at 811 (4th ed. 2004).

2. JOHN EDWARD MURRAY, JR., *MURRAY ON CONTRACTS* § 125, at 812 (4th ed. 2001).

3. However, the issue of amounts less than actual damages is also addressed briefly in Part 2.2.2 *infra*.

4. SCHLECHTRIEM & SCHWENZER, *COMMENTARY ON THE UN CONVENTION ON THE INTERNATIONAL SALE OF GOODS (CISG)* 93, ¶ 44 (Ingeborg Schwenzer ed., 3d ed. 2010).

5. Cf. FARNSWORTH, *supra* note 1, at § 12.18, at 812–13 (explaining the common law as limiting fixed sums to those that are “compensatory” in nature—in contrast, by implication, to those that are “punitive” in nature).

6. See, e.g., FARNSWORTH, *supra* note 1, at § 12.18, at 811–12; MURRAY, *supra* note 2, at § 125, at 812–13.

7. COMMENTARY ON THE UN CONVENTION OF THE INTERNATIONAL SALE OF GOODS (CISG) 74, ¶ 23 (Peter Schlechtriem & Ingeborg Schwenzer eds., 2d. ed. 2005).

a “fixed sum” as a “penalty” in the event of breach will depend on the applicable domestic national law—likely rendering the clause valid in some jurisdictions and invalid in others.<sup>8</sup> This traditional view has recently been challenged in commentary suggesting that issues involving any agreement for a fixed sum—whether liquidated as a reflection of actual damages or coercive as a penalty—should be resolved by reference to the CISG and should be generally enforced.<sup>9</sup> The CISG Advisory Council is also currently considering the issue.<sup>10</sup> The purpose of this article is to explore and evaluate these newly suggested rationalizations for diverging from the traditional view, as well as the original basis and continuing vitality of that traditional view.

The article begins with a description of the traditional approach to penalty clauses found in contracts governed by the CISG and addresses two distinct challenges to the traditional methodology (Part 2). The article then goes on to address the two underlying principles relied upon by any challenge to the traditional orthodoxy—party autonomy (Part 3) and uniformity (Part 4). Finally, the article concludes by suggesting the continuing vitality of the traditional view, fully relegating the validity of any “penalty” clause to domestic national law—without reference to the CISG.

## 2. THE TREATMENT OF PENALTY CLAUSES FOUND IN CONTRACTS GOVERNED BY THE CISG

The CISG does not expressly address “fixed sums,” whether intended to liquidate damages or deter breach. Thus, we begin with the parties’ right to agree upon the payment of a fixed sum in the event of a breach, which is unquestionably established by Article 6, as a simple derogation from the default remedies provided by the CISG. However, such an agreement by the parties remains subject to any question of validity, which Article 4 relegates to domestic national law.<sup>11</sup> In an effort to avoid the application of domestic law on validity, on its own terms, one might suggest that we look to the CISG to interpret and apply that domestic law, or one might suggest that penalty clauses do not actually raise an issue of validity, as that term is used in CISG

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8. See, e.g., JOHN O. HONNOLD, UNIFORM LAW FOR INTERNATIONAL SALES UNDER THE 1980 UNITED NATIONS CONVENTION § 408.1, at 582 (Harry M. Flechtner ed., 4th ed. 2009); JOSEPH LOOKOFSKY, UNDERSTANDING THE CISG IN THE USA 24 (2d ed. 2004).

9. See *infra* Part 2.2.

10. CISG Advisory Council, Schedule of Work, at <http://www.cisgac.com/default.php?sid=113>.

11. See *infra* Part 2.1.

Article 4.<sup>12</sup> However, each of these suggested rationales fails to establish a sound basis for reference to the CISG in deciding the enforceability of a penalty clause, and nothing in Articles 6 or 7, or their underlying principles, provides any basis for a contrary result.<sup>13</sup>

### 2.1. Article 4 and the “Validity” of a Penalty Clause

CISG Article 4 provides that “except as otherwise expressly provided in this Convention, it is not concerned with the validity of a contract or any of its provisions . . . .”<sup>14</sup> Thus, the initial question in determining whether or not the Convention governs “penalty” clauses is whether such clauses raise questions of “validity,” as that term is used in Article 4. An issue of illegality, such as to render a contract “void” is almost certainly one of “validity,” governed by otherwise applicable law—and not by the Convention.<sup>15</sup> U.S. law governing the sale of goods renders a “penalty” clause “void”<sup>16</sup> based on the common law policies abhorring penalties in contract remedies, in much the same manner that U.S. law would render a contract for the sale of heroin void. Thus, U.S. domestic law firmly establishes that the issue is one of “validity,” under U.S. law. Domestic law characterizations of “validity” are not, however, dispositive.<sup>17</sup>

The “validity exception” of Article 4(a) is limited by its introductory clause, “except as otherwise expressly provided in this Convention.” Moreover, this phrase is broadly read to include express provisions of the CISG that impliedly address a particular issue and, thereby, preclude resort to any domestic law of validity.<sup>18</sup> Thus, to the extent that the CISG expressly or impliedly addresses the issue directly, it will be governed by the Convention—and not by domestic law—irrespective of whether it is characterized under domestic law as a question of validity.<sup>19</sup> A common

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12. See *infra* Part 2.2.

13. See *infra* Part 2.3.

14. CISG art. 4(a).

15. See HONNOLD, *supra* note 8, at 78 (using the example of the validity of a contract for the sale of heroin—an agreement rendered invalid for illegality in many jurisdictions).

16. See U.C.C. § 2-718(1) (2003).

17. See, e.g., PETER HUBER, *THE CISG: A NEW TEXTBOOK FOR STUDENTS AND PRACTITIONERS* 21 (2007).

18. Franco Ferrari, *The Interaction between the United Nations Convention on Contracts for the International Sale of Goods and Domestic Remedies*, in 71 *RABELS ZEITSCHRIFT FÜR AUSLÄNDISCHES UND INTERNATIONALES PRIVATRECHT* 52, 64–66 (2007), available at <http://www.cisg.law.pace.edu/cisg/biblio/ferrari16.html>.

19. Milena Djordjevic, *Declaration of Price Reduction under the CISG: Much Ado About Nothing?*,

example is provided by CISG Article 11, which eliminates any requirements with respect to form. Some domestic laws may require a signed writing and characterize the issue as one of “validity.” However, this form requirement would not be a matter of validity, as the term is used in Article 4, because it is expressly addressed in Article 11.<sup>20</sup> In a similar vein, resort to domestic law and characterizations of validity may be precluded in the event the issue is impliedly governed by the CISG.<sup>21</sup> However, there is nothing in the Convention that expressly or impliedly addresses the issue of penalty clauses.<sup>22</sup> As such, traditional commentaries on the Convention have consistently concluded that the validity of a penalty clause must be determined by reference to domestic national law.<sup>23</sup>

## 2.2. *Challenges to the Traditional Orthodoxy*

Pascal Hachem and Bruno Zeller have recently suggested, in separate challenges to the traditional orthodoxy, that the validity of a penalty clause in a contract otherwise governed by the CISG must also be determined by reference to the CISG, albeit under somewhat different theories. Hachem acknowledges that Article 4 provides that the validity of fixed sums is governed by domestic law,<sup>24</sup> but suggests that one must apply international standards in interpreting and applying that domestic law—notwithstanding domestic interpretations to the contrary.<sup>25</sup> He then suggests that such international standards must be derived from the CISG.<sup>26</sup> In contrast, Zeller suggests that the question of fixed sums is not one of validity under Article 4 at all and is, therefore, governed directly by the CISG.<sup>27</sup> However, upon closer

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in UN CONVENTION ON CONTRACTS FOR THE INT’L SALE OF GOODS (CISG) 69, 69, ¶ 15 (Kroll, Mistelis & Viscasillas eds., 2011).

20. See HONNOLD, *supra* note 8, at 583; Secretariat Commentary to CISG art. 4, para. 3 (Commentary on Article 4 of the 1978 Draft).

21. See, e.g., HUBER, *supra* note 17, at 21 (providing an example whereby any domestic law treating errors or mistakes with respect to the character of the goods as an issue of validity would be impliedly preempted by the complete treatment of the relevant issues within the Convention).

22. Professor Zeller’s position to the contrary is fully addressed *infra* in Part 2.2.2.

23. See, e.g., HONNOLD, *supra* note 8, at 582; LOOKOFKY, *supra* note 8, at 24; Schlechtriem & Schwenger, *supra* note 7, at 74, ¶ 23; Djordjevic, *supra* note 19, at 74–75.

24. Pascal Hachem, *Fixed Sums in CISG Contracts*, 13 VINDOBONA J. INT’L COM. L. & ARB. 217, 221–22 (2009) [hereinafter Hachem, *Fixed Sums*]; Pascal Hachem, *Agreed Sums in CISG Contracts*, 3 BELGRADE L. REV. 140, 145 (2011) [hereinafter Hachem, *Agreed Sums*]; Schwenger, *supra* note 4, at 93.

25. Hachem, *Fixed Sums*, *supra* note 24, at 222; Hachem, *Agreed Sums*, *supra* note 24, at 145.

26. Hachem, *Fixed Sums*, *supra* note 24, at 222; Hachem, *Agreed Sums*, *supra* note 24, at 145; see also *infra* Part 2.2.1.

27. See generally Bruno Zeller, *Penalty Clauses: Are They Governed by the CISG?*, 23 PACE INT’L

examination, neither of these two theories provides a sound basis for reference to the CISG in determining the validity of a fixed sum.

*2.2.1. Interpretation and Application of Domestic Law Governing Validity by Reference to the CISG*

Having unequivocally acknowledged that Article 4 relegates the validity of a penalty clause to otherwise applicable domestic national law, Pascal Hachem nevertheless suggests that the issue must be ultimately resolved by reference to the general principles of the CISG. He reaches this conclusion by arguing, with scant support,<sup>28</sup> that one must interpret and apply the governing domestic law “by applying an international standard,” and further suggesting that the issue “must not be decided in accordance with domestic case law.”<sup>29</sup> This is a rather remarkable proposition—and one that seemingly stands the familiar principle of uniformity under CISG Article 7(1) on its head.

In circumstances in which a matter is deemed to raise a question of validity under Article 4, the issue is said to reflect an “external gap” in the Convention.<sup>30</sup> While Article 7 plays a preeminent role in filling “internal gaps” in the Convention—issues governed, but not expressly settled within it—Article 7 plays no role in filling “external gaps.”<sup>31</sup> Hachem relies on Article 7(1) in support of his proposed “international standard” for interpreting and applying domestic law. However, such an approach is

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L. REV. 1, 3 (2011); *see infra* Part 2.2.2.

28. *See* Hachem, *Fixed Sums*, *supra* note 24, at 222 (providing no authority for the use of the Convention to interpret and apply domestic law); SCHLECHTRIEM & SCHWENZER, *supra* note 4, at 93 n.151 (citing only Hachem’s previous article for authority); Hachem, *Agreed Sums*, *supra* note 24, at 145 (citing only Hachem’s previous article and commentary for authority, along with a citation to a commentary by Ferrari). The Ferrari commentary cited by Hachem does not, however, appear to provide any support for the idea of interpreting domestic law by reference to the Convention. In paragraph 22, Ferrari merely addresses the “functional equivalence” test for determining whether the issue is governed by domestic law or the CISG. *See* Franco Ferrari, in SCHLECHTRIEM AND SCHWENZER: KOMMENTAR ZUM EINHEITLICHEN UN-KAUFRECHT, art. 4, ¶ 22 (Peter Schlechtriem & Ingeborg Schwenzer eds., 2008). Inasmuch as Hachem starts from the premise that a penalty clause is governed by domestic law, the “functional equivalence” test arguably has no relevance to his analysis. Ferrari does go on, in the following paragraph 23, to suggest that one must resort to both domestic law and the CISG in applying the “functional equivalence” test. But this is done only for purposes of determining whether the CISG preempts the application of domestic law—and not for purposes of using the Convention to interpret that domestic law.

29. Hachem, *Fixed Sums*, *supra* note 24, at 222; *see also* Hachem, *Agreed Sums*, *supra* note 24, at 145 (explaining that the underlying policies of the CISG must displace an relevant domestic policies in interpreting and applying governing domestic law).

30. HONNOLD, *supra* note 8, at 79.

31. *Id.*



inconsistent with one of the most basic principles of Article 7 itself—the principle of uniform application of law.

In recognizing the international character of the CISG and requiring a consistent interpretation and application of its provisions across national borders, Article 7(1) seeks to promote a uniform application of the CISG, irrespective of forum or circumstances. Notably, the Uniform Commercial Code—one of the domestic laws that Hachem would interpret and apply by reference to the CISG, instead of domestic case law and policies—also provides for uniform interpretation and application.<sup>32</sup> No serious commentator would argue that one should resort to domestic law to interpret the CISG.<sup>33</sup> This would be flatly contrary to the requirement of Article 7(1), because it would undermine uniformity. It seems remarkably inconsistent, and somewhat hypocritical, to resort to the principle of “internationality” contained in Article 7(1) in a manner that would equally undermine the principle of “uniformity” mandated by the domestic law at issue.

The use of the CISG to interpret domestic law lacks support within the CISG itself, because it is contrary to the basic principle of uniformity in the interpretation and application of law—whether the CISG or domestic national law. Thus, absent some basis for asserting that the CISG directly governs the validity of a penalty clause, the issue should be determined solely by reference to domestic law.

### *2.2.2. Direct Application of the CISG to Enforce a Penalty Clause*

Bruno Zeller asserts that the validity of a penalty clause is directly governed by the CISG because the CISG provides a “functionally adequate solution” to the issue, thus avoiding any need to resort to domestic national law under Article 4.<sup>34</sup> In effect, Zeller suggests that an express provision of the CISG—Article 74—impliedly answers the question, thereby avoiding the operation of the “validity exception” under Article 4(a). Zeller also seems to suggest a separate argument based on domestic law characterizations. This latter issue will be addressed first in order to avoid conflating the two.

Zeller appears to argue that the domestic common law approach to penalty clauses is actually one of “non-enforcement,” rather than one of

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32. See U.C.C. § 1-103(a)(3) (providing interpretation and application of the Code to promote its underlying purposes and policies, including uniformity); U.C.C. § 1-301 (providing no distinction between the application of the Code in domestic and international transactions).

33. Of course, U.S. courts have all too often done so, but that does not justify this improper practice.

34. Zeller, *supra* note 27, at 8.

“invalidity,” thus apparently avoiding any invocation of Article 4—even under a domestic law characterization of the issue.<sup>35</sup> However, this characterization is contrary to at least U.S. law governing the sale of goods, which specifically characterizes a penalty clause as “void,”<sup>36</sup> just as any illegal transaction is deemed void. Inasmuch as a “penalty” clause raises a question of “validity,” it is not governed by the CISG, unless one can find some basis within the CISG for avoiding the validity exception of Article 4. Answering this latter question requires an autonomous determination as to whether a penalty clause raises an issue of “validity,” as that term is used in Article 4.

Zeller relies on the “functional equivalence test” of whether an issue is one of “validity,” as the term is used in Article 4. This test provides a means of determining whether the issue falls within the phrase “except as otherwise expressly provided in this Convention,” and is therefore governed by the Convention directly.<sup>37</sup> In searching for a “functional equivalent” solution regarding any issues raised by penalty clauses, Zeller points us to Article 74.<sup>38</sup> Zeller focuses on the second sentence of Article 74—the foreseeability limitation—seemingly to argue that Article 74 at least impliedly provides for enforcement of penalty clauses, because such a clause is foreseeable, as an express provision of the parties’ agreement. However, this arguably amounts to the use of the “tail” (foreseeability) to “wag the dog” (compensation for the aggrieved party’s expectation damages). Instead, one should begin any analysis of Article 74 with its first sentence.

Article 74 provides for actual damages caused by the breach. Such “[d]amages must not place the aggrieved party in a better position that it would have enjoyed had the contract been properly performed.”<sup>39</sup> In contrast, Zeller himself admits that a penalty clause, by its nature, provides for an amount that is “greater than the actual damage.”<sup>40</sup> An award of punitive damages in excess of a party’s actual loss is contrary to the basic principles

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35. *Id.* at 8–9. Zeller also asserts that domestic law rendering excessive fixed sums void, as a penalty, is somehow unfair in that it has no effect on sums deemed too small. *Id.* at 4–5. However, unconscionability provides the appropriate mechanism in that case. See Joseph M. Lookofsky, *Loose Ends and Contorts in International Sales: Problems in the Harmonization of Private Law Rules*, 39 AM. J. COMP. L. 403, 409–11 (1991) (addressing and explaining the application of unconscionability doctrine to fixed sums that substantially understate actual damages in the *North Sea Cranes* case).

36. See U.C.C. § 2-718(1); see also HONNOLD, *supra* note 8, at 582.

37. See Ferrari, *supra* note 18, at 64–66.

38. See Zeller, *supra* note 27, at 10–13.

39. CISG-AC Opinion No. 6, *Calculation of Damages under CISG Article 74*, para. 9, available at <http://cisgw3.law.pace.edu/cisg/CISG-AC-op6.html>. Rapporteur: Professor John Y. Gotanda, Villanova University School of Law, Villanova, Pennsylvania, USA.

40. Zeller, *supra* note 27, at 1.

of Article 74.<sup>41</sup> Thus, if one were to find a “functionally equivalent” test in the first sentence of Article 74, it would be far more likely to preclude the enforcement of a penalty clause than to support it, as urged by Zeller.<sup>42</sup> The second sentence—the foreseeability test—does not, as Zeller suggests, provide a fully sufficient independent basis for enforcing anything. Instead, it simply provides a limit on those damages otherwise provable under the first sentence, as indicated by its first two words—“such damages.” In other words, “such damages” as established under the first sentence are further subject to the additional limit of foreseeability under the second sentence. This article does not suggest that the enforcement of a penalty clause is to be determined by reference to the CISG. However, if it is so determined, then Article 74 in fact provides a powerful argument *against* the enforcement of any agreement to the payment of a penalty, as damages.<sup>43</sup>

Moreover, the Secretariat Commentary to CISG Article 46 specifically characterizes the issue raised by a penalty clause as one of “validity.”<sup>44</sup> Article 46 provides a buyer with a broad right to require specific performance by the seller, and a penalty clause is, in some respects, similar in that it may, by contract, seek to deter breach and require performance.<sup>45</sup> This broad right to performance in Article 46 might reasonably be seen as an express provision of the Convention impliedly precluding resort to domestic law governing the validity of a penalty clause intended as a contractual means of coercing performance. However, the Secretariat Commentary makes clear that such is not the case, explaining that Article 46 “does not have the effect of making [penalty] clauses valid in those legal systems which do not otherwise recognize their validity.”<sup>46</sup>

Admittedly, the Article 46 Secretariat Commentary does not directly address the issue of whether Article 74 might somehow preclude an

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41. See CISG-AC Opinion No. 6, *supra* note 39.

42. Zeller also argues that certain actual damages are difficult to ascertain, thereby justifying the enforcement of a penalty clause. See Zeller, *supra* note 27, at 12–13. However, such “actual” damages may be addressed through a proper “liquidated damages” clause. There is no need to enforce “penalties” to achieve this result, and the distinction remains important under the common law.

43. See MICHAEL BRIDGE, THE INTERNATIONAL SALE OF GOODS: LAW AND PRACTICE, para. 11.38 (2d ed. 2007) (suggesting that the CISG governs the issue and renders penalties unenforceable, as inconsistent with Article 74).

44. See Secretariat Commentary, art. 42 [draft counterpart to CISG art. 46], para. 10, available at <http://www.cisg.law.pace.edu/cisg/text/secomm/secomm-46.html> (noting that “penalty clauses” are “invalid” in some legal systems where their “validity” may not be recognized).

45. *Id.*

46. *Id.* The connection between penalty clauses and the remedy of specific performance, as well as the significance of Article 28, are explored more fully *infra* Part 4.

examination of the validity of a penalty clause under domestic law. However, it would seem quite logical that the Secretariat Commentary would address any provision most likely to have such an effect, such as Article 46, and would seem equally illogical that the Secretariat Commentary would be silent regarding another provision that would ultimately dictate that the entire issue is governed by the CISG. In short, Article 74 fails to establish that penalty clauses are otherwise governed by the CISG, and their validity is fully governed by domestic national law.<sup>47</sup>

Finally, the drafting history of the CISG strongly suggests that it was not intended to govern penalty clauses. While specifically recognizing the importance of the issue, the drafters deemed it too complex and problematic to be addressed at the time, specifically leaving it for otherwise applicable law<sup>48</sup>—whether in a subsequent convention or domestic law. No uniform solution has yet been adopted,<sup>49</sup> thus leaving the issue to otherwise applicable domestic national law.

### *2.3. Reliance on Articles 6 and 7 to Support Reference to the CISG in Validating a Penalty Clause*

At bottom, the approaches of both Hachem and Zeller rest on the principles found in Articles 6 and 7 of the CISG.<sup>50</sup> However, nothing in either of these articles mandates a departure from the traditional rule that the validity of fixed sums must be determined entirely by reference to otherwise applicable law—and not the CISG. As explained below, the parties' exercise of autonomy under Article 6 remains limited to any issue of validity under applicable law—and not the CISG<sup>51</sup> and Article 7(1) has no application to the issue of validity, because that issue is not governed by the CISG.<sup>52</sup> Moreover,

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47. Hachem also attempts to rely on Article 74 to support the idea that penalties are fully enforceable by reference to the general principles of the CISG, as found in this provision. Hachem, *Agreed Sums*, *supra* note 24, at 146. However, his arguments are equally unavailing for the same reasons explained herein.

48. Djordjevic, *supra* note 19, at 74, ¶ 26; Hachem, *Fixed Sums*, *supra* note 24, at 218.

49. Hachem, *Fixed Sums*, *supra* note 24, at 218.

50. See generally Hachem, *Fixed Sums*, *supra* note 24; Hachem, *Agreed Sums*, *supra* note 24; see generally Zeller, *supra* note 27; see also Phanesh Koneru, *The Int'l Interpretation of the UN Convention on Contracts for the Int'l Sale of Goods: An Approach Based on General Principles*, 6 MINN. J. GLOBAL TRADE 105, 140–42 (1997) (suggesting that any provision for a fixed sum must be governed by the Convention solely by reference to Articles 6 and 7).

51. See *infra* Part 3.

52. See *infra* Part 4.

the lack of such uniformity with respect to the general principles underlying differential treatment of penalty clauses is recognized within the CISG itself.

### 3. ARTICLE 6 AND THE PRINCIPLE OF PARTY AUTONOMY

CISG Article 6 admittedly supports the idea of party autonomy as one of the most fundamental general principles underlying the CISG.<sup>53</sup> Thus, the parties may certainly derogate from the default rule of Article 74, providing for expectation damages, and, instead, fix a penal sum in the event of a breach.<sup>54</sup> However, as a means of overcoming the express language of Article 4, this argument either proves too little, or it proves too much. It proves too little in that the parties' autonomy—no matter how expansive under Article 6—is expressly subject to the applicable law governing the exercise of that autonomy, a subject that CISG Article 4 expressly leaves to other law. The late Professor Farnsworth explains the relationship in hierarchical terms as follows:

Article 6 purports to give the parties an unqualified power to vary the effect of the Convention by agreement. On the other hand, article 4 makes it clear that, absent a contrary provision, the Convention does not affect any rule of domestic law dealing with the "validity" of a contract provision. *Taken together, articles 6 and 4 create a tripartite hierarchy, with domestic law on validity at the top, the agreement of the parties in the middle, and the Convention at the bottom.*<sup>55</sup>

Thus, the parties' autonomy cannot serve as a basis for ignoring otherwise applicable domestic laws governing validity, including domestic law governing penalty clauses, because the exercise of that autonomy remains subject to Article 4.

In attempting to narrow the application of Article 4, one might perhaps suggest that the parties' autonomy under Article 6 is subject only to limits on validity relating to the issue of consent. If there is no question of the validity of consent,<sup>56</sup> then the general principle of party autonomy under Article 6 gives life to a "penalty" clause notwithstanding Article 4. However, under this approach, the parties' consent under Article 6 would overcome an otherwise

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53. See Michael Van Alstine, *Consensus, Dissensus, and Contractual Obligation Through the Prism of Uniform International Sales Law*, 37 VA. J. INT'L L. 1, 36–41 (1996).

54. Djordjevic, *supra* note 19, at 74, ¶ 26.

55. E. Allan Farnsworth, *Review of Standard Forms or Terms Under the Vienna Convention*, 21 CORNELL INT'L L.J. 439, 441 (1988) (emphasis added).

56. Issues of the validity of consent would likely include issues such as fraud, duress, or capacity—all of which arguably go to the effectiveness of any exercise of autonomous consent.

applicable law rendering a contract illegal—such as the earlier referenced contract for the same of heroin.<sup>57</sup> Thus, an argument limiting validity to issues of consent clearly proves too much. At the end of the day, Article 6 does not provide any basis for ignoring the express language of Article 4, which relegates the issue of the validity of a penalty clause to otherwise applicable domestic law.

#### 4. ARTICLE 7 AND THE PRINCIPLE OF UNIFORMITY

Article 7 of the CISG unquestionably mandates an internationally uniform approach to the interpretation of the Convention by reference to the general principles upon which it is based.<sup>58</sup> However, Article 7 has no application to issues not governed by the Convention.<sup>59</sup> Moreover, the treatment of penalty clauses is not internationally uniform, and the divergence between civil and common law treatment is recognized within the CISG itself.<sup>60</sup>

##### *4.1. Article 7(1) and the Interpretation of the Convention*

Article 7(1) is limited by its own language to “the interpretation of [the CISG].” Article 4(a) provides that the CISG “is not concerned with . . . the validity of the contract or any of its provisions . . .” Thus, Article 7(1) and its mandate “to promote uniformity” arguably have no relevance in determining the validity of a penalty clause.

Perhaps one might suggest that Article 7(1) is in fact being used to interpret the provisions of the CISG governing damages, which would arguably “govern” a penalty clause, assuming such a clause to be valid. However, this seems to conflate two distinct issues—that of validity and that of the law governing such clause “if it is valid.” While the use of Article 7(1) is perfectly appropriate in the case of the latter, it seems premature in the case of the former.

To the extent that one might argue that Article 7(1) mandates a preference for international norms over domestic law, generally, on issues not governed by the convention, this seems inconsistent with the approach provided in Article 7(2). Even in the case of issues governed by the convention, Article 7(2) mandates reference to the “general principles on which [the CISG] is

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57. *See supra* Part 2.1.

58. CISG arts. 7(1) and 7(2).

59. *See infra* Part 4.1.

60. *See infra* Part 4.2.

based,” but “in the absence of such principles,” defers to domestic national law—not to international norms. Moreover, even if one does look for such international uniformity, that search yields a clear and significant divide between the civil and common law worlds.

#### *4.2. Comparative Legal Treatment of Penalty Clauses*

The treatment of penalty clauses is fundamentally different, as between civil and common law legal systems. A penalty clause is generally enforceable under the civil law,<sup>61</sup> while it is not enforceable under the common law.<sup>62</sup> Moreover, the same theoretical underpinnings of these different approaches to penalty clauses can also be found in the two legal systems’ different approaches to the remedy of specific performance.<sup>63</sup>

##### *4.2.1. Civil Law*

The civil law generally enforces fixed sums, whether intended to approximate damages or to deter breach. Thus, a fixed sum intended as a “penalty” will typically be enforced. While a court may adjust the amount of a “penalty” it considers excessive, the fact that the “penalty” tends to deter breach does not, itself, preclude enforcement. The sole issue is the amount of the penalty and whether that amount is deemed excessive.<sup>64</sup>

In view of the fact that most civil law regimes provide limits on the amount of a penalty clause, one might be tempted to suggest a similarity between the civil and common law approach in that each provides certain limits on the amount of a contractually agreed upon fixed sum. However, any such suggestion fails to account for the fundamentally different approaches taken by the two systems in justifying such limits. As explained below, the common law abhors any penalty—irrespective of the amount.

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61. See *infra* Part 4.2.1.

62. See *infra* Part 4.2.2.

63. See *infra* Part 4.3.2.

64. Hachem, *Agreed Sums*, *supra* note 24, at 142.

#### 4.2.2. *Common Law*

The common law<sup>65</sup> grants contracting parties substantial autonomy in defining their respective rights and obligations. However, their autonomy in defining remedies for breach is subject to certain limits,<sup>66</sup> including limits on “fixed sums” payable in the event of breach. A sum fixing an amount or method of determining “liquidated damages” is enforceable, while a sum fixing a “penalty” intended to deter breach is void.<sup>67</sup>

The parties to a contract may stipulate in advance to a specified amount or methodology for determining damages in the event of a specified breach. As long as the amount represents a reasonable effort to ascertain in advance or “liquidate” damages that might otherwise be uncertain or difficult to prove, the provision will be enforceable as “liquidated damages.”<sup>68</sup> Such clauses offer substantial utility in providing a remedy in the event of breach while retaining the basic common law focus on “compensatory” rather than “punitive” damages for breach of contract.<sup>69</sup> In contrast, a “penalty” clause runs afoul of this same basic approach.

A “penalty” clause goes beyond compensating the aggrieved party for its promissory loss and has the effect of deterring breach and compelling performance.<sup>70</sup> This is known as the “*in terrorem*” effect of a penalty clause and is, in fact, the intent of such a clause.<sup>71</sup> This deterrent effect is inconsistent with the fundamental remedial approach of the common law focus on redressing breach through damages—but not compelling performance.<sup>72</sup> Moreover, it would be unjust to “punish” a party based on what is essentially a “strict liability” standard for breach of contract.<sup>73</sup> Common law damages are intended to be, in effect, neutral as between performance and payment of

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65. This article does not purport to provide a complete survey of common law legal regimes or any nuanced differences between them in the treatment of “fixed sums.” Instead, the U.S. common law, as well as its reflection in U.C.C. Article 2, is used here as exemplary of the common law approach to the issue.

66. *See, e.g.*, U.C.C. §§ 2-718(2)–(3) (providing statutory limits on the parties’ contractual rights to limit or exclude certain remedies).

67. FARNSWORTH, *supra* note 1, at 811–17.

68. *Id.*

69. *Id.*

70. *Id.*

71. *Id.*

72. RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 149 (8th ed. 2011).

73. *XCO Int’l, Inc. v. Pac. Scientific Co.*, 369 F.3d 998, 1001–02 (7th Cir. 2004); Charles J. Goetz & Robert E. Scott, *Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach*, 77 COLUM. L. REV. 554, 560–61 (1977).



damages for non-performance.<sup>74</sup> This common law hostility towards penalty clauses originated in courts of equity, which by the end of the 17th century were no longer willing to enforce the historical “penal bond,”<sup>75</sup> sending the parties instead to courts of law for a determination of actual monetary damages.<sup>76</sup> Today, the common law renders a penalty clause generally unenforceable, and, in the case of U.S. law governing the sale of goods, deems such a penalty “void.”<sup>77</sup>

Notably, the parties to a contract may accomplish some of the same objectives as those they might seek to accomplish through a penalty clause by framing the fixed sum due as a contractual performance obligation instead of a remedy for breach. For example, a bonus that gives significant incentives for performance would likely be fully enforceable, whereas a penalty for non-performance would not. A fixed sum may also fairly be characterized as one of two “alternative performances,” in which case the promised contractual obligation to pay the amount due is likely to be enforced.<sup>78</sup>

One might be tempted to point to these examples in suggesting that the common law approach to fixed sums is more about form than substance. However, there is a crucial difference between the above contractual promise to pay money as a performance obligation and a “penalty” clause triggered by a breach—the former involve the parties’ rights and obligations, while the latter involves a remedy for breach sought from a court or arbitral tribunal after the parties’ agreement has run aground on the rocks of an intractable dispute. When parties negotiate a contract, they typically focus far more on their performance “rights and obligations” than on “remedies” in the event of breach. Parties expect to perform—not to breach<sup>79</sup>—so their exercise of

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74. See Goetz & Scott, *supra* note 73, at 558. This indifference between performance and payment of damages is often referred to as the “indifference principle.” Hachem suggests that the value of a party’s right to specific performance must be accounted for in applying this principle, thereby justifying the use of a penalty intended to deter breach. See Hachem, *Fixed Sums*, *supra* note 24, at 221. However, this mixes the civil law right to such performance with a common law principle based on the damages as the normal remedy. The civil law right to performance and the right to enforce a penalty clause go hand-in-glove—just as the common law preference for damages and the invalidity of a penalty clause.

75. Perhaps the most famous “penal bond” was that of Antonio’s promise of a “pound of flesh” to Shylock in the event of default on his promise to repay 300 Ducats. See generally WILLIAM SHAKESPEARE, *THE MERCHANT OF VENICE*. See also STEWART MACAULEY ET AL., *CONTRACTS: LAW IN ACTION*, vol. I, *THE INTRODUCTORY COURSE* 107 (3d ed. 2010) (discussing the “pound of flesh” and *The Merchant of Venice* in connection with penalty clauses).

76. FARNSWORTH, *supra* note 1, at 812; MURRAY, *supra* note 2, at 812–13.

77. U.C.C. § 2-718(1).

78. See JOSEPH M. PERILLO, *CALAMARI AND PERILLO ON CONTRACTS* 535–36 (6th ed. 2009).

79. It is sometimes said that art imitates life. Thus, one might reasonably look to Shakespeare for the quintessential example of this phenomenon in *The Merchant of Venice*. Upon hearing of the “pound

autonomy with respect to the former arguably deserves greater deference than the latter.

The common law approach to penalties has unquestionably been subject to substantial criticism by both courts<sup>80</sup> and commentators.<sup>81</sup> However, its continued application by the courts—in spite of such criticism—also proves its continuing vitality as domestic U.S. law.<sup>82</sup> The most common modern justification for the rule is based on the theory of “efficient breach.” In effect, society as a whole may be better served by a breach. If so, as long as the aggrieved party receives monetary damages compensating for its expectation loss, breach will be more efficient than performance.<sup>83</sup>

Critics argue that the “efficient breach” theory is flawed—both as a matter of business reality and economic theory. Contrary to the traditional theory of “efficient breach”—a penalty clause deterring breach may actually be more efficient, because this will simply lead the parties to negotiate and share the economic fruits of the contemplated breach.<sup>84</sup> However, this ignores the very real challenges inherent in negotiating in the context of what is essentially a bilateral monopoly,<sup>85</sup> as well as the potential economic interests of third parties in an efficient breach.

Critics of the common law approach also often argue in favor of the “utility” of penalty clauses by pointing to various forms of damages that are difficult to calculate or prove.<sup>86</sup> However, these arguments miss the point that a true “liquidated damages” provision is, in fact, enforceable—thereby

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of flesh” demanded by Shylock as a penal bond to secure Antonio’s performance, Bassanio rejects the idea, fearing this penalty is simply too steep. However, Antonio happily accepts the deal offered by Shylock, certain in the knowledge that “within these two months, that’s a month before this bond expires, I do expect return of thrice three times the value of this bond.” WILLIAM SHAKESPEARE, *THE MERCHANT OF VENICE*, Scene III. Antonio, a sophisticated merchant, simply could not fathom the possibility that he would breach his promise to repay Shylock at the appointed time. However, we know that sometimes the best of intentions may be thwarted by unexpected events—whether in art or in life.

80. See, e.g., *XCO Int’l*, 369 F.3d at 1001–02; *Lake River Corp. v. Carborundum Co.*, 769 F.2d 1284, 1288–89 (7th Cir. 1985).

81. See generally Goetz & Scott, *supra* note 73; Kenneth W. Clarkson et al., *Liquidated Damages v. Penalties: Sense or Nonsense*, 1978 WIS. L. REV. 351 (1978).

82. See, e.g., *XCO Int’l*, 369 F.3d at 1002–03; *Lake River*, 769 F.2d at 1289. Hachem points to departures from this standard approach in certain areas, such as insurance law; Hachem, *Agreed Sums*, *supra* note 24, at 148. However, these departures are sui generis and typically involve what is, essentially, a tort, such as bad faith breach of an insurance contract.

83. See *XCO Int’l*, 369 F.3d at 1001; *Lake River*, 769 F.2d at 1289. For a more thorough analysis the theory of “efficient breach,” see POSNER, *supra* note 72, at 149.

84. See Goetz & Scott, *supra* note 73, at 567–68.

85. See POSNER, *supra* note 72, at 78.

86. See *id.* at 160.

addressing damages that are difficult to calculate or prove—and provisions requiring the losing party to pay actual damages, which are simply difficult to calculate or prove, are fully enforceable.

The above analysis is exemplary only and is not intended to be exhaustive or to suggest that the common law approach is necessarily superior to that of the civil law. In fact, there is much to commend in each. The point, for purposes of this article, is simply to establish that the common law will not enforce a “penalty” clause, as such, and that the reasons underlying this approach are reasonably defensible and not wholly irrational.

#### *4.2.3. The Relationship between the Treatment of Penalty Clauses and the Treatment of Performance Based Remedies*

The difference between the civil and common law treatment of penalty clauses is mirrored in the treatment of performance-based remedies in the two legal systems. The civil law treats specific performance as the ordinary remedy for breach, while the common law treats specific performance as an extraordinary remedy.<sup>87</sup> The common law approach to specific performance is based on the same doctrinal underpinnings as its approach to penalty clauses—the ordinary common law of remedies is neutral, as between performance and payment of damages in compensation for non-performance. As in the case of penalty clauses, the common law’s treatment of performance-based remedies reflects a general “economic” approach to remedies.<sup>88</sup>

Admittedly, a court may, under proper circumstances, order specific performance, notwithstanding the fact that such an award may be inconsistent with this general neutrality. However, a discretionary award of specific performance by a court of equity is far different than the grant of power to one of the parties to compel performance through a punitive damages clause.

A more complete comparison of civil and common law approaches to performance-based remedies is beyond the scope of this article. However, the essential nature of the relationship between the treatment of penalty clauses and performance-based remedies within the two legal systems is important in understanding why the former are not governed by the CISG. The Convention,

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87. See Franco Ferrari, *What Sources of Law for Contracts for the International Sale of Goods? Why One Has to Look Beyond the CISG*, 25 INT’L REV. L. & ECON. 314, 337 (2005).

88. See *XCO Int’l*, 369 F.3d at 1001 (explaining that the doctrine of efficient breach drives not only the common law approach to penalties, but also the common law treatment of damages, as the normal remedy, and specific relief, as extraordinary).

itself, recognizes the divergent views in the treatment of performance-based remedies, and the Secretariat Commentary on the Convention recognizes the connection between this divergence and the issue of penalty clauses.

#### *4.2.4. Divergent Views Recognized within the CISG Itself*

The treatment of specific performance within the CISG demonstrates a clear recognition of the fundamental differences between the two legal systems with respect to a basic principle underlying contract remedies—the civil law favors performance, while the common law is neutral as between performance and compensation for non-performance. To the extent there is any question as to the application and effect of Article 4 as excluding from the CISG any question as to the validity of a penalty clause, Article 7(2) directs us to the general principles underlying the CISG. We find such a principle recognizing this fundamental difference between the civil and common law in the interplay between Articles 46, 62, and 28.<sup>89</sup>

Articles 46 and 62, essentially, adopt the civil law approach to specific performance. However, Article 28 limits the application of either in instances in which a common law enforcing court would not order specific performance under its own law.<sup>90</sup> The Secretariat Commentary to what would become Article 46<sup>91</sup> not only notes the limit provided through Article 28, but also specifically notes the similarities between the legal remedy of specific performance and a contractual penalty clause used as a deterrent to breach.<sup>92</sup> The Commentary goes on to note that such a “penalty clause” is “invalid” in many legal systems, and that nothing in CISG Article 46 has “the effect of making such clauses valid in those legal systems which do not otherwise

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89. Hachem suggests that Article 28 has no relationship to any issue other than that of specific performance. Hachem, *Fixed Sums*, *supra* note 24 n.38. However, the underlying principles supporting the common law approach to issues of specific performance and issues as to the validity of penalty clauses are very much related, as recognized in the Secretariat Commentary to Article 46.

90. See Ferrari, *supra* note 87, at 337–38 (explaining that the combined effects of Articles 46, 62, and 28 reflected a compromise between the civil and common law approaches). Hachem seemingly suggests that the existence of Articles 46 and 62 within the CISG reflect an international consensus on the issue of performance based remedies. See Hachem, *Agreed Sums*, *supra* note 24, at 148. However, this argument fails to account for the essential role of Article 28.

91. This is Article 42 of the 1978 draft.

92. Secretariat Commentary to the CISG art. 46, paras. 9 and 10. Hachem argues that the treatment of specific performance in Articles 46 and 62 provides support for his position that penalty clauses must ultimately be enforced based on the general principles of the Convention. Hachem, *Agreed Sums*, *supra* note 24, at 146. However, this argument is strikingly inconsistent with the treatment of this issue in the Secretariat Commentary.

recognize their validity.”<sup>93</sup> Thus, the Secretariat Commentary provides clear recognition that the validity of a penalty clause is governed by otherwise applicable law, even in the context of a transaction to which the CISG (including Article 46) is applicable.

In summary, CISG Article 4 expressly relegates the validity of a penalty clause to otherwise applicable law—not the CISG; Article 6 does not give the parties any right to change this result; and the compromise represented by Articles 46, 62, and 28 provides further indication that the CISG left the specific issue of the enforceability of penalty clauses to otherwise applicable domestic national law.

## 5. CONCLUSION

The issue of fixed sums is an important one in international transactions in goods. As such, it seems quite reasonable to suggest that a uniform approach to the treatment of agreements for fixed sums is desirable. However, a single uniform approach across divergent legal systems today remains elusive, and any effort to bridge this divide by reference to the CISG is quite simply “a bridge too far.”

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93. Secretariat Commentary to the CISG art. 46, para. 10.