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**PENALTY CLAUSES: ARE THEY GOVERNED BY  
THE CISG?**

**Bruno Zeller\***

I. INTRODUCTION

This paper will only analyze one issue; namely whether the inclusion of penalty clauses or fixed sums into a contract is governed by the Convention of International Sale of Goods (CISG)<sup>1</sup> and, therefore, falls *inter alia* under Article 74. In essence, a penalty clause or fixed sum is a pre-determined amount of money which becomes due in the event of a breach of contract. The word “penalty” is used in this paper to describe the fact that the amount due is greater than the actual damage. The main reasons to include penalty clauses in contracts are to “reduce legal costs, [to provide] time for producing evidence, and [to mitigate] the risk of losing litigation or arbitral proceedings due to the required level of proof

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<sup>1</sup> United Nations Convention on Contracts for the International Sale of Goods, Apr. 11, 1980, 19 I.L.M. 668 [hereinafter CISG].

not being met.”<sup>2</sup>

It is undisputed that the CISG does not expressly address the issue of penalty clauses; therefore, the question is whether general principles within the CISG will lead to a solution on this point.<sup>3</sup> It is argued in this paper that if a fixed sum equals the actual damages, such a sum would be enforced; thus, the issue is not the fixing of an amount, but rather the amount itself.

It is understood that the CISG is an autonomous legislation devoid of words with domestic connotations and, therefore, the common law distinction between penalty clauses and liquidated damages does not apply.<sup>4</sup> However, a discussion of the common law, as well as selected civil law positions, is still of value in order to understand Article 4 of the CISG because the Convention does not apply when it comes to “the validity of the contract or any of its provisions.”<sup>5</sup> Additionally, some arbitrators have argued that Article 6 of the CISG suggests that the inclusion of a penalty clause will be tantamount to an implied exclusion of the CISG on this point.<sup>6</sup> Further consideration will be given to the general principle of freedom of contract, which is an important concept throughout the CISG.

This article will argue that penalty clauses are covered by the CISG and many courts, tribunals, and commentaries have taken far too narrow a view. An examination of the general principles, as laid down within the CISG, will lead to the conclusion that penalty clauses are within the ambit of the CISG.

## II. PENALTY CLAUSES IN DOMESTIC LAW

Australian law provides the aggrieved party with two causes of action to recover the penalty clause: an action on a debt and an action for damages.<sup>7</sup> The main advantage of an action on a debt is that such an ac-

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<sup>2</sup> Pascal Hachem, *Fixed Sums in CISG Contracts*, 13 VINDOBONA J. INT'L COM. L. & ARB. 217, 218 (2009).

<sup>3</sup> E. Allan Farnsworth, *Damages and Specific Relief*, 27 AM. J. COMP. L. 247, 248 (1979).

<sup>4</sup> For a full treatment on this point, see Bruno Zeller, *Four-Corners – The Methodology for Interpretation and Application of the UN Convention on Contracts for the International Sale of Goods (May 2003)* (Ph.D. thesis, University of Melbourne), available at <http://www.cisg.law.pace.edu/cisg/bib-lit/4corners.html>.

<sup>5</sup> See CISG, *supra* note 1, art. 4.

<sup>6</sup> See Bruno Zeller, *The CISG And The Opting Out Clause Pursuant To Article 6: A Corrective Reply*, 20 (8) MEALEY'S INT'L ARB. REP. 1-6 (2005).

<sup>7</sup> JEANNIE PATERSON ET AL., *PRINCIPLES OF CONTRACT LAW*, ch. 28 (2d ed. 2005).

tion “may not be dependent on a breach of contract ... [and] [p]roof of loss is not required.”<sup>8</sup>

However, the action under a contract is contingent on the fact that the penalty clause is deemed to be a liquidated damages claim and not penal in nature, in which case the clause would be unenforceable.<sup>9</sup> In such situations, a conflict arises between the freedom of contract and the need for judicial interference to set aside what parties bargained for. In essence, the law is concerned about protecting the debtor rather than the freedom of contract and party autonomy. In *Ringrow Pty. Ltd. v. BP Austl. Pty. Ltd. (Ringrow)*, the court noted that the law on penalty is an exception to the general rule.<sup>10</sup> The court stated on this point, “the propounded penalty must be judged ‘extravagant and unconscionable in amount’. It is not good enough that it should be lacking in proportion. It must be ‘out of all proportion.’”<sup>11</sup>

The principles upon which *Ringrow* relied were developed in *Dunlop Pneumatic Tyre Co Ltd v. New Garage and Motor Co. Ltd.*, in which Lord Dunedin ruled, “[i]t will be held to be a penalty if the sum stipulated for is extravagant and unconscionable in amount in comparison with the greatest loss that could be conceivably be proved to have followed from the breach.”<sup>12</sup> On the other hand, Lord Dunedin also stated:

It is no obstacle to the sum stipulated being a genuine pre-estimate of damage that the consequences of the breach are such as to make precise pre-estimation almost an impossibility. On the contrary, that is just the situation when it is probable that pre-estimated damage was the true bargain between the parties.<sup>13</sup>

The problem with this approach is that the court must interpret the intent of the parties at the time the contract was formed. Under the common law, the parole evidence rule only addresses facts using an objective approach.<sup>14</sup> Background information from pre-contractual negotiations is ignored, as it is generally rejected as not falling within the objec-

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<sup>8</sup> CHRISTOPHER LAWRENCE & EDMUND BARTON CHAMBERS, PENALTY CLAUSES IN AGREEMENTS: ENFORCEMENT AND AVOIDANCE 1 (2009), available at [http://www.abc44.com/articles/Lawrence\\_18\\_March\\_2009.pdf](http://www.abc44.com/articles/Lawrence_18_March_2009.pdf).

<sup>9</sup> *Id.*

<sup>10</sup> See *Ringrow Pty. Ltd. v. BP Austl. Pty. Ltd.* [2005] 224 CLR 656, 669 (Austl.).

<sup>11</sup> *Id.*

<sup>12</sup> *Dunlop Pneumatic Tyre Co. Ltd. v. New Garage & Motor Co. Ltd.*, [1915] A.C. 79 (H.L.) 87 (Appeal taken from Eng.).

<sup>13</sup> *Id.* at 87-88.

<sup>14</sup> See generally Bruno Zeller, *The Parol Evidence Rule and the CISG – A Comparative Analysis*, 36 COMP. INT’L L. J. OF S. AFR. 3 (2003).

tive approach.<sup>15</sup>

The questions left unanswered by *Ringrow* was whether the liquidated damages clause is “exclusive” or if the court deems the clause to be penal in nature and whether the right to damages is lost. The issue is that the clause *ab initio* is not invalid. It only becomes unenforceable should the court finds that it is a penalty and not liquidated damages.

This treatment of penalty clauses contradicts German law, which gives penalty clauses full effect.<sup>8</sup> However, Article 343 of the German Civil Code (BGB) allows the breaching party to advance arguments that the court should reduce the penalty amount to a “reasonable amount by judicial decision.”<sup>16</sup> Likewise, French law generally follows the same method.<sup>17</sup>

Despite the substantial differences between common law and civil law, as well as German law in particular, in practice these differences are significantly reduced.<sup>18</sup> Arguably, the German approach is far simpler and provides more certainty to contractual parties. Simply put, the breaching party is forced to pay the agreed sum or the plaintiff may only receive what the court determines are “actual” damages.

However, it appears that common law courts, on one hand, are not prepared to amend the effects of a poor bargain as “‘men of business’ ... [enter contracts] with their eyes open,”<sup>19</sup> but on the other hand, the courts are prepared to assist with poor bargains related to penalty clauses. Arguably, the risk allocation between contracting parties, which is in “balance” at the formation of the contract, is disturbed once a contract containing a penalty clause is breached. The problem with the common law approach is highlighted in *Piggott Foundations v. Shepherd Construction*, in which the breaching party was only held liable for the amount of liquidated damages despite the fact that the actual damages were far

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<sup>15</sup> See generally, Bruno Zeller, *Determining the Contractual Intent of Parties under the CISG and the Common Law – A Comparative Analysis*, 4 EUR. J.L. REFORM 629 (2002).

<sup>16</sup> Bürgerliches Gesetzbuch [BGB] [Civil Code], Jan. 2, 2002, Bundesgesetzblatt [BGBL.] I, 343, as amended (Ger.), translation available at [http://www.gesetze-im-internet.de/englisch\\_bgb/englisch\\_bgb.html#BGBen-gl\\_000P343](http://www.gesetze-im-internet.de/englisch_bgb/englisch_bgb.html#BGBen-gl_000P343)

<sup>17</sup> See Unfair Contract Terms Act; France Art. 1152 CC; Germany § 343 CC (BGB).

<sup>18</sup> See BASIL MARKESINIS, HANNES UNBERATH & ANGUS JOHNSTON, *THE GERMAN LAW OF CONTRACT: A COMPARATIVE TREATISE* 444 (2d ed. 2006).

<sup>19</sup> Thomas Thompson, *A Fresh Look at Liquidated Damages*, 22 CONSTRUCTION L.J. 289, 295 (2006).

greater.<sup>20</sup> If the clause had been judged to be penal in nature, the clause would have been unenforceable and, therefore, the claimant could have relied on a claim for damages, which would have been equal to the actual loss. It could be argued that an astute contractual party will always overestimate damages because, in that event, they party may be compensated for actual damages. Conversely, if the damages are underestimated, no recourse is possible, which is not a very satisfactory solution for maintaining certainty.

### III. THE CISG AND PENALTY CLAUSES

Literature and case law on this issue is sparse, which suggests that the question of penalty clauses has not created great controversy. However, the debate still surfaces from time to time and usually two articles, Article 4 and Article 6, are used in an attempt to explain why penalty clauses are not part of the CISG.<sup>21</sup>

The problem with this approach is that focusing on one article alone does not take the full scope of the CISG into consideration. Within the four corners of the Convention, general principles are the glue that hold the individual provisions together. To that end, Articles 7 and 8 are the key to unlocking the Convention and provide the methodology to finding and applying general principles. Just because the CISG does not explicitly include an issue, to automatically exclude it from the scope of the Convention is inappropriate. It can be argued that exclusion is only merited when the matter is either expressly excluded by a provision or is not contained within a general principle as noted in Article 7.

#### A. Article 6

Some commentators have argued that the inclusion of a penalty clause automatically means that Article 6 is applicable and an implied opt-out of the CISG has taken place.<sup>22</sup> However, these arguments are patently wrong. Courts and scholars clearly state that an implied opt-out is only possible in extreme cases.<sup>23</sup> In one case, the French Supreme Court

<sup>20</sup> See *Pigott Founds. Ltd. v. Shepherd Constr. Ltd.*, [1993] 67 B.L.R. 48, 51 (Eng.).

<sup>21</sup> See Marcus S. Jacobs & Yanming Huang, *An Arbitrator's Powers And Duties Under Art 114 Of Chinese Contract Law In Awarding Damages In China In Respect of A Dispute Under A Contract Governed By CISG*, MEALEY'S INT'L ARB. REP., May 2005.

<sup>22</sup> *Id.* at 42.

<sup>23</sup> PETER SCHLECHTRIEM & INGBORG SCHWENZER, COMMENTARY ON THE UN CONVENTION ON THE INTERNATIONAL SALE OF GOODS (CISG) 112 (Ingeborg Schwenzler, 3d ed. 2010).

applied the French Civil Code despite the applicability of the CISG.<sup>24</sup> In that case, the Convention was ignored, which is a common problem. The court noted:

In so ruling, although the pleading invoked the provisions of both the Civil Code and the Vienna Convention, and because [the Court] could not find thereupon that the parties voluntarily excluded application of the Vienna Convention, the Court of Appeal violated the above laws . . . . [The Supreme Court] REVERSES and ANNULS in its entirety the judgment rendered by the Court of Appeal of Bordeaux on 15 October 2007 regarding the [above-mentioned] parties. [The Supreme Court] orders the cause of action and the parties to be reinstated in the position where they were prior to the above-mentioned judgment, and in the interest of justice, orders the Court of Appeal of Bordeaux to hold a new trial before a new tribunal.<sup>25</sup>

This case clearly indicates that unless both parties expressly exclude either the CISG in its entirety or “derogate from or vary the effects of any of its provisions,”<sup>26</sup> a court is reluctant to read an implied derogation into a contract.<sup>27</sup> Before an opt-out of the CISG can take place, pursuant to Article 6, either express intent must be present or the matter is not governed by the CISG and, thus, a gap exists, which must be filled by domestic law.

The problem is that the above argument is only valid at the choice of law stage. The CISG is clearly an “opt- out” Convention; that is, it will apply automatically pursuant to Article 1 in its entirety unless it is expressly excluded or varied pursuant to Article 6.<sup>28</sup>

It follows that Article 6 has another function; the CISG may be treated as the putative governing law and its own terms shall determine the outcome of any disputed matter. If a contractual term fixes a sum which exceeds the damages allowed under Article 74, the doctrine of freedom of contract found in Article 6 will resolve this issue. Article 6 specifically allows parties to “derogate from or vary the effects of any of its provisions,”<sup>29</sup> which includes Article 74. In effect, the penalty clause

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<sup>24</sup> Cour de cassation [Cass.][supreme court for judicial matters], Nov. 3, 2009, Bull. Civ. IV, No. T 08-12.399 (Fr.), *translation available at* <http://cisgw3.law.pace.edu/cases/091103f1.html>.

<sup>25</sup> *Id.*

<sup>26</sup> CISG, *supra* note 1, art. 6.

<sup>27</sup> Cour de cassation [Cass.][supreme court for judicial matters] com., Nov. 3, 2009, Bull. Civ. IV, No. T 08-12.399 (Fr.), *translation available at* <http://cisgw3.law.pace.edu/cases/091103f1.html>.

<sup>28</sup> SCHLECHTRIEM & SCHWENZER, *supra* note 23, at 193.

<sup>29</sup> CISG, *supra* note 1, art. 6.

has varied the effects of Article 74 by allowing excess sums to be claimed. The mere presence of a penalty clause invokes Article 6 without a need to either expressly, or by implication, invoke the right to “derogate from or vary the effects of any of its provisions.”<sup>30</sup>

#### *B. Article 4*

An investigation into whether penalty clauses are not governed by the CISG logically starts with Article 7, the interpretative article. Article 7(1), in brief, promotes “uniformity in its application and the observance of good faith in international trade.”<sup>31</sup> The effect of this provision is that all matters covered by the CISG cannot be interpreted using domestic legal principles or rules. Simply put, all matters which are expressly settled within the CISG may not be settled using domestic laws or interpretive principles. However, it must be noted that the CISG does not cover all areas of sales law and, thus, gaps need to be filled by recourse to domestic law applicable by “virtue of the rules of private international law.”<sup>32</sup>

Gaps may either be matters not settled within the CISG or issues expressly excluded from the CISG. However, Article 7(2) notes that some “matters are governed by this Convention which are not expressly settled.”<sup>33</sup> These matters are to be governed by general principles upon which the matter is based. The CISG does not expressly mention penalty clauses,<sup>34</sup> hence, they are not expressly excluded from nor included in the CISG. Therefore, pursuant to Article 7(2), the next step is to determine which general principle penalty clauses would fall under, which requires investigation to ascertain whether the particular issue is a general principle found within the CISG.<sup>35</sup>

Penalty clauses are only applicable if a party is in breach of the contract; hence, they form part of the compensation regime available to the aggrieved party. Penalty clauses are compensatory in nature and the CISG contains such a regime. In other words, a consequence of the breach is the enlivenment of the clause, which falls under Article 74. Penalty clauses are calculated to recuperate damages once a breach occurs.

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<sup>30</sup> *Id.*

<sup>31</sup> For a full treatment of Article 7, see Zeller, *supra* note 4, at ch. 6.

<sup>32</sup> CISG, *supra* note 1, art. 7(2).

<sup>33</sup> *See id.*

<sup>34</sup> A penalty clause for the purpose of this paper is a clause where the stated amount is above actual damages.

<sup>35</sup> *See* CISG, *supra* note 1, art. 7(2)

There is, however, an exception to this argument; specifically, in situations where the applicable governing domestic law declares a contract invalid if it contains a penalty clause. In such cases, Article 4 must be consulted. The first sentence of this article states that the CISG “governs the formation of the contract of sale and the rights and obligations of the seller and the buyer arising from such a contract.”<sup>36</sup> This immediately suggests that Article 7 must be applied, not only to ascertain what is included in the Convention, but also to assist in defining what the CISG excludes explicitly or by implication. When Article 4 is tested, with the aid of Article 7, a tribunal or court could apply validity of contract in two ways.

First, validity could be interpreted and, hence excluded, according to the same generally accepted criteria such as illegality, immorality, and capacity. Second, validity can only be excluded from the Convention if, through the gap-filling procedure, recourse to domestic law must be sought. Enderlein and Maskow believe that “national law on validity will not apply when the CISG provides a *functionally adequate solution* to the problem which has been settled nationally by questioning the validity of the contract.”<sup>37</sup> The broadest argument is that if there is a general principle contained in the CISG, the Convention would prevail in the case of conflict, thus restricting the application of Article 4 of the CISG as envisaged by Enderlein and Maskow. Schlechtriem put the issue very succinctly when he noted:

What amounts to invalidity has to be analysed ... “autonomously” i.e., as a concept of the CISG interpreted according to the guidelines of Article 7(1). In order to preserve or achieve a uniform application of the term “validity,” it is not the words used in domestic law and their interpretation under domestic law, but the functions of the respective rules and provisions that are decisive . . . .<sup>38</sup>

French and German law does not declare contracts invalid due to penalty clauses. Hence, in these two domestic legal systems, Article 4 is not enlivened. A problem exists under common law since penalty clauses are unenforceable. However, “unenforceable” is not to be confused with “invalidity.” The clause containing a sum of money to be paid in

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<sup>36</sup> *Id.* art. 4.

<sup>37</sup> FRITZ ENDERLEIN & DIETRICH MASKOW, INTERNATIONAL SALES LAW, UNITED NATIONS CONVENTION ON CONTRACTS FOR THE INTERNATIONAL SALE OF GOODS, CONVENTION ON THE LIMITATION PERIOD IN THE INTERNATIONAL SALE OF GOODS 41 (1992).

<sup>38</sup> COMMENTARY ON THE UN CONVENTION ON THE INTERNATIONAL SALE OF GOODS (CISG) 65-66 (Peter Schlechtriem & Ingeborg Schwenzer eds., 2d ed. 2005).

case of a breach of the contract is enforceable and thus valid. It is only the stated amount, which is unenforceable, but not the underlying principle of compensation because the clause is still valid. Otherwise, no rights to damages would exist. It is, therefore, argued that even under common law, Article 4 is not applicable. Honnold argued correctly that “the substance rather than the label” of the domestic rule of validity is relevant.<sup>39</sup> Honnold states:

Validity is not excluded in total as [A]rticle 4 clearly stipulates that domestic law applies only to validity issues, which are not expressly stated within the Convention, (except as otherwise expressly provided in the Convention). The answer is clear if article 7(2) in relation to gap filling is consulted. If the CISG governs matters but not exclusively, then general principles will aid in the construction and interpretation of these matters within the "Four Corners" of the CISG. Validity is only excluded if it is not related to either the formation or rights and obligations of buyers and sellers.<sup>40</sup>

One of the rights and obligations of the buyer and seller is to pay or to receive compensation for the breach of contract such as damages. If the common law and civil law approaches are analyzed again, it is obvious that it is not the clause, but the sum itself, which is the focus of diverse judgments. In *Dunlop Pneumatic Tyre Company*, Lord Dunedin states “[i]t is no obstacle to the sum stipulated being a genuine pre-estimate of damage.”<sup>41</sup> The CISG does not expressly govern the issue of whether a sum is penal in nature or not, however, it does govern the issue of damages, which is the underlying reason to stipulate a sum of money be paid in case of breach of contract.<sup>42</sup>

In sum, Article 4 is not applicable and the distinction between liquidated damages and penalty clauses is not a feature of the CISG. Any pre-estimate of losses is an agreed sum to cover damages in case of a breach of contract. It complies not only with the general principle of compensation for losses, but also with the principle of party autonomy.

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<sup>39</sup> JOHN O. HONNOLD, *UNIFORM LAW FOR INTERNATIONAL SALES UNDER THE 1980 UNITED NATIONS CONVENTION* 115 (2d ed. 1991).

<sup>40</sup> Zeller, *supra* note 4, ch. 6(4).

<sup>41</sup> *Dunlop Pneumatic Tyre Co. Ltd. v. New Garage & Motor Co. Ltd.*, [1914] UKHL 1, [1915] A.C. 79 (H.L.) (appeal taken from Eng.), *available at* <http://www.bailii.org/uk/cases/UKHL/1914/1.html>.

<sup>42</sup> *See CISG, supra* note 1, art. 74.

*C. Article 74*

It is a general principle of contract law that a party is bound by the terms of the contract unless a term is invalid or unenforceable. As noted above, invalidity does not apply in this case since the issue of remedies for damages is governed by the CISG under Article 74 in conjunction with Article 6.

The first sentence of Article 74 limits the claim to the “sum equal to the loss, including loss of profit.”<sup>43</sup> It could be argued that this sentence limits the damages to the actual loss suffered. However, the second sentence indicates that the damage cannot exceed “the loss which the party foresaw or ought to have foreseen at the time of the conclusion of the contract.”<sup>44</sup> Therefore, Article 74 fulfils two functions. Article 74’s first sentence addresses situations where the contract simply is silent on the consequences of a breach of contract.<sup>45</sup> It is declaratory in character and merely indicates that losses also include loss of profit. However, the second sentence of the CISG caps the losses to the sum, which the party ought to have foreseen “at the time of the conclusion of the contract.”<sup>46</sup>

Furthermore, in order to assist in determining what was foreseen by the parties Article 8 must also be consulted. Article 8 allows the court or tribunal to examine pre-contractual, contractual, as well as post-contractual conduct in ascertaining the intent of the parties.<sup>47</sup> The application of subjective, as well as objective intent, pursuant to Article 8, allows one to determine whether the party in breach knew or ought to have known the consequences of the breach. The Supreme Court of Austria stated:

From Art[icle] 74 [of the]CISG arises the necessity to determine to what degree a reasonable person within the meaning of Art[icle] 8(3) [of the]CISG in the circumstances known to [seller] at the time of the conclusion of the contract could (or should) foresee such problems and expenses; and if need be, also whether or to what degree such damages (in this manner determinable, foreseeable, exceeding the loss, and resulting directly from [seller]’s breach of contract) of [buyer] were actually foreseeable for [seller] at the time of conclusion of the contract.<sup>48</sup>

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<sup>43</sup> *Id.*

<sup>44</sup> *Id.*

<sup>45</sup> *Id.*

<sup>46</sup> *Id.*

<sup>47</sup> See CISG, *supra* note 1, art. 8.

<sup>48</sup> Oberster Gerichtshof [OGH] [Supreme Court] Jan. 14, 2002, 7 Ob 301/01t, Entscheidungen des österreichischen Obersten Gerichtshofes in Zivilsachen [SZ]

The best indication of foreseeability of loss is achieved by including a term in the contract stipulating a sum of money. The Austrian Supreme Court<sup>49</sup> noted this by indicating:

The obligor must reckon with the consequences that a reasonable person in his situation (Art. 8(2) CISG) would have foreseen considering the particular circumstances of the case. Whether he actually did foresee this is as insignificant as whether there was fault. Yet, subjective risk evaluation cannot be completely ignored: if the obligor knows that a breach of contract would produce unusual or unusually high losses, then these consequences are imputable to him.<sup>50</sup>

It simply follows that by including a fixed sum into a contract the subjective risk evaluation, and hence, the problem of having to defend a possibly unusually high loss is alleviated. Hence, it can be argued that Article 8, together with Article 74, leads to the conclusion that penalty clauses as such are included within the general principles of the CISG and are enlivened in the two articles.

Regarding the issue of whether penalty clauses can be moderated, the Appellate Court of Arnhem stated “Article 8 . . . is about the interpretation of the intent of a party. That is no basis for moderation . . . . Therefore this question must be answered according to German law.”<sup>51</sup>

The court correctly noted that there is no basis for moderation in Article 8, but incorrectly relied on German Law. Article 8 does not supply a cause for moderation because the intent of the parties establishes whether a penalty clause should apply. Hence, a court must uphold contractual terms where the intent of the parties is clear. To rely on German law is not appropriate because Article 4 of the CISG does not apply, as the term is not invalid.

In contrast, in the *Foam Board Machinery* case,<sup>52</sup> the International Chamber of Commerce (ICC) International Court of Arbitration went further, agreeing that not only actual damages, but also the penalty clause can be claimed:

At issue was seller's right to the compensation fee plus damages. Seller's position was, the compensation fee is “a price, a consideration other than in

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(Austria), translation available at <http://cisgw3.law.pace.edu/cases/020114a3.html>.

<sup>49</sup> *Id.*

<sup>50</sup> *Id.*

<sup>51</sup> Franco Ferrari & Albert H. Kritzer, Editorial Remarks, *CISG CASE PRESENTATION: Diepeveen-Dirkson v. Nieuwenhoven Veehandel* (Aug. 15, 2005), available at <http://cisgw3.law.pace.edu/cases/950822n1.html>.

<sup>52</sup> *Foamed Board Machinery* (It. v. Fi.), Case No. 7585 of 1992, Certified Award (ICC Int'l Ct. Arb.) (Mar. 20, 2007), available at <http://cisgw3.law.pace.edu/cases/927585i1.html>.

addition to damages suffered.” Advising that the contract clause at issue has to be interpreted in accordance with the CISG and “in conformity with the general principles on which it is based” as provided in Article 7, the tribunal reasoned that: [T]here is evidence that the compensation fee also “has a nature different from damages in compensation of a loss . . . .” Seller is entitled to the compensation fee in addition to damages pursuant to Article 74.<sup>53</sup>

The court made a distinction between penalty clauses and ordinary damages.<sup>54</sup> Whether an interpretation of the CISG leads to this conclusion is debatable. However, an examination of the contract, pursuant to Article 8, may well have led the arbitral tribunal to the decision that both penalties and damages can be claimed.

In another ICC case, the arbitrator, “[c]iting Article 53 CISG (confirming the obligation by the buyer ‘to pay the price for the goods . . . under the conditions provided by the Contract’) and in other relevant articles . . . held that seller is entitled to recover the penalty set forth in the contract.”<sup>55</sup>

Simply put, the parties clearly assumed the risk of incurring the stated damages in the event of a breach of contract. The real issue is whether the courts and tribunals are inclined to read the CISG in a such a way to find recourse in domestic law or a solution within the Convention’s general principles.

This view finds support in the notion that loss of profit, as stated in Article 74, also allows compensation for loss of goodwill and reputation, which of course needs to equate to a loss of turnover. As with the term “penalty clause,” the terms of “goodwill and reputation “are not expressly stated in any of the Convention’s provisions. Goodwill and reputation are part of second line losses because they do not flow directly from the breach of contract, but are a result of it.<sup>56</sup> It is foreseeable that a businessperson would use the goods either directly or indirectly to generate a profit for his or her business. Hence, goodwill and reputation are items, which fall under “loss of profit” and are covered by the CISG.

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<sup>53</sup> Albert H. Kritzer, Editorial Remarks, *CISG CASE PRESENTATION: Foamed Board Machinery Case (It. v. Fi.)*, Case No. 7585 of 1992 (ICC Int'l Ct. Arb.) (Mar. 20, 2007), available at <http://cisgw3.law.pace.edu/cases/-927585i1.html>.

<sup>54</sup> See *id.*

<sup>55</sup> Albert H. Kritzer, Case Digest, *CISG CASE PRESENTATION, Chemical Compound Case (Ro. v. Nl.)*, Case No. 8247 of 1996 (ICC Int'l Ct. Arb.) (Feb. 15, 2007), <http://cisgw3.law.pace.edu/cases/968247i1.html>

<sup>56</sup> See BRUNO ZELLER, DAMAGES UNDER THE CONVENTION ON CONTRACTS FOR THE INTERNATIONAL SALE OF GOODS 123 (2005).

Goodwill and penalty clauses do have a common denominator, namely they form part of the overall calculation of damages. Article 7.4.2 of the UNIDROIT Principles may be used as guidance in defining the scope of Article 74 to include “any gain of which [the aggrieved party] has been deprived as a consequence of the non performance . . . and must be understood in a wide sense . . . [and] may cover a reduction in the aggrieved party’s assets or an increase in its liabilities.”<sup>57</sup> Therefore, Article 74 may be used as “long arm” instrument to recover damages that have gone beyond the confines of a breach between two parties since it promotes full compensation. Hence, the reach of Article 74 can be extended to downstream or upstream relationships that are affected by the breach of the contract.<sup>58</sup>

The fact is that Article 74 covers a wide range of losses which are “equal to the loss” and are a “consequence of the breach.”<sup>59</sup> It can be argued that Article 74 does not allow losses to exceed the actual amount. However, the CISG does not only consist of one general principle, but several. The issue is that it would be against the spirit of the CISG to look at an issue such as penalty clauses and only look at one principle to resolve the problem when the issue at hand traverses several general principles.

The issue of penalty clauses are governed by two principles. If the amount of the contractual clause is judged to be more than the actual damages, the excess can be accommodated within the CISG as representing the maxim of party autonomy as stated in Article 6 and the fact that contractual clauses must be given force of law unless they fall under Article 4 of the Convention.

#### IV. CONCLUSION

Any investigation of a matter, which is not explicitly governed by the CISG, should be commenced by keeping the words of Honnold in mind. He argued correctly that the “substance rather than the label” is relevant.<sup>60</sup>

It is irrelevant whether the common law distinguishes between pe-

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<sup>57</sup> INT’L INST. FOR THE UNIFICATION OF PRIVATE LAW, UNIDROIT PRINCIPLES OF INT’L COMMERCIAL CONTRACTS Art. 7.4.2, at 234 (2004), available at <http://www.unidroit.org/english/principles/contracts/principles2004/-integralversionprinciples2004-e.pdf>.

<sup>58</sup> See Zeller, *supra* note 4, at 125.

<sup>59</sup> CISG, *supra* note 1, art. 74.

<sup>60</sup> Honnold, *supra* note 39, at 115.

nalty clauses and liquidated damages, or that Germany does not make a distinction at all. Making a comparison would amount to an ethnocentric approach, which is not allowed pursuant to Article 7(1) of the CISG and has been discredited. Of importance is whether a matter, which is not expressly settled by the Convention, falls within one of its several general principles. Penalty clauses are such an issue and this paper demonstrates that penalty clauses may be accommodated by two of the CISG's general principles, namely freedom of contract and compensation for losses. Furthermore, Schlechtriem, among others, has noted that Article 4 of the Convention does not apply since penalty clauses are covered by the CISG despite the fact that a domestic law might label penalty clauses as being invalid.<sup>61</sup>

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<sup>61</sup> SCHLECHTRIEM & SCHWENZER, *supra* note 23, at 1104.