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## Penalty Clauses – What Has Changed?

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# PENALTY CLAUSES – WHAT HAS CHANGED?

Bruno Zeller\*

## ABSTRACT

Building on two seminal cases that consider the character of penalty clauses, *Paciocco v Australia and New Zealand Banking Group Ltd* from Australia and *Cavendish Square Holding BV v. Talal El Makdessi* from England, this Article sheds a new light on the treatment of fixed sums and argues that the view on whether penalty clauses are governed by the CISG requires new considerations.

Importantly, this Article demonstrates a two-step approach to the analysis of penalty clauses: 1) whether the sum in question is penal in nature, and 2) if so, whether the CISG determines the fate of the penalty clause by reference to its general principles. Considering new international developments, this Article argues that such clauses should generally be enforced.

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## I. INTRODUCTION

In *Paciocco v Australia and New Zealand Banking Group Ltd*,<sup>1</sup> the Australian Court considered whether late payment fees are unenforceable penalty clauses. Importantly, the decision demonstrates that the Australian definition and application of penalty clauses is different from the English common law, as laid out in *Cavendish Square Holding BV v. Makdessi*.<sup>2</sup> Interestingly enough, however, the Australian High Court noted:

All of the common law jurisdictions are rich sources of comparative law whose traditions are worthy of the highest respect, particularly those of the United Kingdom as the first source. No doubt in a global economy convergence, particularly in commercial law, is preferable to divergence even if harmonisation is beyond reach.<sup>3</sup>

In a landmark decision, the English High Court has similarly commented that penalty clauses are “an ancient, haphazardly constructed edifice which [have] not weathered well.”<sup>4</sup>

As such, it is time to revisit the debate surrounding penalty clauses in the United Nations Convention on Contracts for the International Sale of Goods,<sup>5</sup> which, at this stage, can still be termed as ‘unresolved.’ Though divergent between the Australian and English legal systems, despite the Australian High Court

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<sup>1</sup> *Paciocco v Austl & NZ Banking Grp Ltd* [2016] HCA 28 (27 July 2016) (Austl.).

<sup>2</sup> *Cavendish Square Holding BV v. Talal El Makdessi* [2015] UKSC 67 (appeals taken from Eng.).

<sup>3</sup> *Paciocco*, [2016] HCA 28, para. 10.

<sup>4</sup> *Cavendish Square Holding BV*, [2015] UKSC 67, para. 3.

<sup>5</sup> U.N. Convention on Contracts for the Int’l Sale of Goods, Apr. 1, 1980, 1489 U.N.T.S. 3 (entered into force Jan. 1, 1988) [hereinafter CISG].

noting that convergence is preferable, the common law is currently settled.<sup>6</sup>

In Part I and II, this Article will explore the Australian and English positions on penalty clauses and how significantly, if at all, they have converged. Its purpose is twofold. First, it will explain the differences in defining penalties between the Australian and English common law. To that end, the Article will first independently analyze how the Australian and English jurisprudence define penalty clauses. The Article will then briefly comment on the strengths and weaknesses of the approaches taken by the two legal systems. The purpose of analyzing the two recent seminal cases decided by the Australian and English courts, *Paciocco v Australia and New Zealand Banking Group Ltd* and *Cavendish Square Holding BV v. Talal El Mkdessi*, is to see what, if anything, the CISG can learn from the recent developments.

In Part III, this Article will revisit the fevered debate surrounding the issue of whether penalty clauses are covered by the CISG. First, it will demonstrate that the CISG defines penalty clauses. Second, this Article will show that the ‘validity clause,’ contained in Article 4 of the CISG,<sup>7</sup> which leaves the enforcement of contracts to domestic law, can be overcome.

An added difficulty with the CISG is the fact that it was constructed as a compromise between the civil and common law systems. As a result, differences between the two legal systems will in some cases present different solutions. The treatment of penalty clauses is a classic example. Professor Graves, a Professor of Law at the Touro College Jacob D. Fushsberg Law Center, put it as follows: “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,

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<sup>6</sup> *Paciocco*, [2016] HCA 28, para. 10.

<sup>7</sup> CISG, *supra* note 5, art. 4.

while the common law treats specific performance as an extraordinary remedy.”<sup>8</sup>

The conclusion of this Article will demonstrate that there are still significant differences in the treatment of penalty clauses, which suggests that a decision of a choice of law is still prudent given that a clause considered to be penal in character can be declared void and unenforceable.

## II. THE AUSTRALIAN POSITION

In its landmark decision, *Paciocco v Australia and New Zealand Banking Group Ltd* (“*Paciocco*”), the Australian High Court noted that late payment fees are not a penalty at common law.<sup>9</sup> The parties did not contest that the late payment fee was higher than the actual costs incurred by the bank, and, not surprisingly, the Federal Court in 2014 held that the fees were a penalty.<sup>10</sup> On appeal, the decision of the Federal Court was overturned,<sup>11</sup> and the Australian High Court affirmed.<sup>12</sup> In essence, the Court upheld the doctrine of the freedom of contract, even in cases where there is uneven bargaining power between parties and where a penalty clause is contained in standard form contracts.<sup>13</sup> Building on *Paciocco*, this section will discuss the Australian definition of a penalty clause.

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<sup>8</sup> Jack Graves, *Penalty Clauses and the CISG*, 30 J.L. & COM. 153, 170 (2012) (citing 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)).

<sup>9</sup> *Paciocco v Austl & NZ Banking Grp Ltd* [2016] HCA 28 (27 July 2016) (Austl.).

<sup>10</sup> *Paciocco v Austl & NZ Banking Grp Ltd* (2014) 309 ALR 249, para. 25 (Austl.).

<sup>11</sup> *Paciocco v Austl & NZ Banking Grp Ltd* (2015) 236 FCR 199 (Austl.).

<sup>12</sup> *Paciocco*, [2016] HCA 28.

<sup>13</sup> Neil Hannan & Nicholas O’Connell, *The Bank Fees Case*, THOMPSON GEER (Aug. 8, 2016), <https://www.tglaw.com.au/corporate/publications/bank-fees-case/>.

(i) *What is a penalty?*

The question is not new. In 1915, Lord Dunedin addressed the issue of penalty clauses in *Dunlop Pneumatic Tyre Company v. New Garage & Motor Company Ltd.* (“*Dunlop*”).<sup>14</sup> Lord Dunedin wrote that “[t]he essence of a penalty is a payment of money stipulated as in terrorem of the offending party” and that “the essence of liquidated damages is a genuine covenanted pre-estimate of damage.”<sup>15</sup> He further added that whether the sum is a penalty or liquidated damages depends on the construction of the terms used in the contract, and that the penalty must be “judged of as at the time of the making of the contract, not as at the time of the breach.”<sup>16</sup> In short, according to *Dunlop*, when considering whether a clause is penal, the first question is whether the agreed sum is a fair pre-estimate of the damages. If it is not, then the agreed sum is a penalty and the law relating to penalty clauses must be applied to determine its enforceability. Relying on *Dunlop* and other case law, each Justice in *Paciocco* found that the late payment fee was not a penalty. Each, however, delivered a separate judgment, as detailed below.

In her judgment, Justice Kiefel began by noting *Dunlop*’s distinction between penalty clauses and liquidated damages.<sup>17</sup> Justice Kiefel emphasized the relevance of *Dunlop* by recognizing and accepting that “a sum stipulated for payment on default may be intended to protect an interest that is different from, and greater than, an interest in compensation for loss caused directly by the breach of contract.”<sup>18</sup> Discussing the “*Dunlop* tests,”<sup>19</sup> Justice

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<sup>14</sup> *Dunlop Pneumatic Tyre Co. Ltd. v. New Garage & Motor Co. Ltd.* [1915] AC 79 (appeal taken from Eng.).

<sup>15</sup> *Id.* at 86 (citing *Clydebank Eng’g. & Shipbldg. Co. v. Don Jose Ramos Yzquierdo y Castaneda* [1905] AC 6 (HL) (appeal taken from Scot.)).

<sup>16</sup> *Id.*

<sup>17</sup> *Paciocco v Austl & NZ Banking Grp Ltd* [2016] HCA 28, para. 16 (27 July 2016) (Austl.) (quoting *Dunlop Pneumatic Tyre Co. Ltd.*, [1915] AC 79 [86]).

<sup>18</sup> *Id.* para. 26.

Kiefel further stressed that the distinction between liquidated damages and a penalty, while useful, should not be treated as a limiting rule.<sup>20</sup> Therefore, pre-estimates or sums reflecting other kinds of loss or damages are not necessarily penal in nature.

Justice Kiefel also relied heavily on the definition propounded by Justices Mason and Deane in *Legione v. Hateley*, which states that “[a] penalty, as its name suggests, is in the nature of a punishment for non-observance of a contractual stipulation; it consists of the imposition of an additional or different liability upon breach of the contractual stipulation.”<sup>21</sup> It is this definition of a penalty clause that appears to be most acceptable as it was also referred to in *Andrews v Australia and New Zealand Banking Group Ltd* (“*Andrews*”),<sup>22</sup> and, significantly, by the United Kingdom Supreme Court in *Cavendish Square Holding BV v. Makdessi*,<sup>23</sup> “albeit in a more qualified sense.”<sup>24</sup> Notably, both of these cases were *ad idem* that penalty clauses cannot be abolished or applied in a restrictive way.

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<sup>19</sup> *Dunlop Pneumatic Tyre Co. Ltd.*, [1915] AC 79 [87-88]. To assist in the determination of whether a clause in a contract is penal, Lord Dunedin offered four tests: 1) whether the “sum stipulated for is extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have followed from the breach;” 2) whether, when the breach consists only in not paying a sum of money, the sum stipulated is a “sum greater than the sum which ought to have been paid;” 3) whether “a single lump sum is made payable by way of compensation, on the occurrence of one or more or all of several events, some of which may occasion serious and others but trifling damage.” *Id.* “On the other hand: [4] [i]t 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.” *Id.*

<sup>20</sup> *Paciocco*, [2016] HCA 28, para. 30.

<sup>21</sup> *Legione v Hateley* (1983) 152 CLR 406, 445, para. 32 (Austl.).

<sup>22</sup> *Andrews v Austl & NZ Banking Grp Ltd* (2012) 247 CLR 205, para. 9 (Austl.).

<sup>23</sup> *Cavendish Square Holding BV v. Talal El Makdessi* [2015] UKSC 67 [para. 31] (appeals taken from Eng.).

<sup>24</sup> *Paciocco v Austl & NZ Banking Grp Ltd* [2016] HCA 28, para. 22 (27 July 2016) (Austl.).



After a thorough analysis of prior case law,<sup>25</sup> Justice Kiefel reached the conclusion that the common feature in all of the jurisprudence is that the sum in question cannot be unconscionable or extravagant, but it can “be inferred from the adjectives chosen that not every sum in excess of what might be strictly compensatory will amount to a penalty.”<sup>26</sup> In essence, the sum cannot be “out of all proportion.”<sup>27</sup> In the case of Mr. Paciocco, Justice Kiefel was of the opinion that he failed to establish that the late payment fee imposed upon him for his failure to make timely payments was a penalty.<sup>28</sup>

In his judgment, Justice Keane analyzed the penalty claim of the plaintiff and noted that “whether a late payment fee is to be characterized as an unenforceable penalty is not to be determined by asking whether the enforcement of the fee will produce profits, even large profits, for the bank.”<sup>29</sup> The argument advanced by Mr. Paciocco that the late payment fee was a penalty as its purpose was to punish him for breaching his contractual obligation by failing to make timely payments or to deter him not performing his contractual obligation failed.<sup>30</sup> Justice Keane reasoned that “the late payment fee is readily characterized by the purpose of ensuring that [the bank’s] revenues are maintained at the level of profitability required by its shareholders.”<sup>31</sup>

Justice Keane explained that, to maintain a level of profitability demanded by shareholders, the bank uses interest payments and late payment fees to generate revenue.<sup>32</sup> The point

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<sup>25</sup> See *Clydebank Eng'g. & Shipbldg. Co. v. Don Jose Ramos Yzquierdo y Castaneda* [1905] AC 6 (HL) (appeal taken from Scot.); *Forrest & Barr v. Henderson et. al.*, [1869] 7 SLR 112 (Scot.); *Hungerfords v Walker* (1989) 171 CLR 125 (Austl.); *Ringrow Pty Ltd v BP Austl Pty Ltd* (2005) 224 CLR 656 (Austl.).

<sup>26</sup> *Paciocco*, [2016] HCA 28, paras. 52-53.

<sup>27</sup> *Id.* para. 57.

<sup>28</sup> *Id.* para. 69.

<sup>29</sup> *Id.* para. 215.

<sup>30</sup> *Paciocco v Austl & NZ Banking Grp Ltd* [2016] HCA 28, para. 215 (27 July 2016) (Austl.).

<sup>31</sup> *Id.* para. 216.

<sup>32</sup> *Id.*

illustrated that late payment fees are not confined solely to reimburse the bank for direct expenses. Instead, they also contribute to the institution's revenue stream.<sup>33</sup> Judge Keane also observed that “an agreed provision avoids the uncertainty and expense of litigation. The benefit of such a provision to both parties and to the legal system is obvious.”<sup>34</sup> The amount in *Paciocco* was not “extravagant and unconscionable . . . in comparison with the greatest loss that could conceivably be proved.”<sup>35</sup> Judge Keane also noted that “in Australia, no legislation authorises the application by the courts of a standard of reasonableness to determine the lawfulness of bank charges,” although it was not an argument that Mr. Paciocco advanced.<sup>36</sup>

In yet another separate opinion, Justice Gageler explained in detail the development of penalty causes in the English law and the treatment of the maxim developed in *Dunlop*: whether “the sum agreed was commensurate with the interest protected by the bargain.”<sup>37</sup> Justice Gageler also referred to *Andrews*, noting that the term ‘penalty’ applies to a “punishment, consisting of the imposition of an additional or different contractual liability for non-observance of a ‘primary’ contractual stipulation.”<sup>38</sup> “Thus, a penalty is a ‘collateral’ stipulation ‘in the nature of a security for and in *terrorem* of the satisfaction of the primary stipulation.”<sup>39</sup>

Importantly, Justice Gageler noted that “*Andrews* did nothing to disturb the settled understanding in Australia that a

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<sup>33</sup> *Id.*

<sup>34</sup> *Id.* para. 284.

<sup>35</sup> *Id.* para. 306 (quoting *Dunlop Pneumatic Tyre Co. Ltd. v. New Garage and Motor Co. Ltd.* [1915] AC 79 [87] (HL) (appeal taken from Eng.)).

<sup>36</sup> *Paciocco v Austl & NZ Banking Grp Ltd* [2016] HCA 28, para. 214 (27 July 2016) (Austl.).

<sup>37</sup> *Id.* para. 142 (quoting *Andrews v Austl & NZ Banking Grp Ltd* (2012) 247 CLR 205, at 236 [75] (Austl.)).

<sup>38</sup> *Id.* para. 118 (citing *Andrews*, (2012) 247 CLR 205, at 216 [9], referring to *Legione v Hateley* (1983) 152 CLR 406, at 445 (Austl.)).

<sup>39</sup> *Id.* (quoting *Andrews*, (2012) 247 CLR 205, at 216 [10]).

contractual provision imposing a penalty is unenforceable at common law without the discretionary intervention of equity.”<sup>40</sup>

Lastly, relying on prior case law Justice Nettle noted:

As will be apparent from the differences between the approach of the primary judge and the reasoning of the Full Court, the outcome of the penalty appeal turns to a large extent on whether this case should be regarded as one of the straight forward kind in which the *Dunlop* tests are ‘perfectly adequate’ to resolve the issues or, whether it should be seen as one of the more complex types of cases referred to in *Cavendish* which necessitate considerations beyond a comparison of the agreed sum and the amount of recoverable damages.<sup>41</sup>

In conclusion, in some cases, there are broader issues that need to be protected and they are not directly quantifiable. This raises the question of whether a penalty clause can even be defined. Stated differently, if a court relies on the *Dunlop* tests, which of the four must be applied? Or, should a court consider all of them? As Judge Nettle observed, positions on penalty clauses have changed since *Dunlop* as it is now “possible to recover unliquidated damages for the breach of an obligation to pay a specified sum and, accordingly, the amount recoverable for the breach of such an obligation is no longer necessarily capable of

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<sup>40</sup> *Id.* para. 122 (quoting *Andrews*, (2012) 247 CLR 205, at 216 [10]).

<sup>41</sup> *Id.* para. 322 (citing *Cavendish Square Holding BV v. Talal El Makdessi* [2015] UKSC 67 [para. 32] (appeals taken from Eng.)).

exact pre-estimation.”<sup>42</sup> Simply put, the question now is whether a “late payment fee [is] extravagant and unconscionable or out of all proportion to the amount which would be recoverable as unliquidated damages.”<sup>43</sup>

Lastly, it is worth noting that in *Andrews*, the High Court held that the penalty doctrine is not confined to obligations arising from a breach of contract.<sup>44</sup> Because *Paciocco* dealt with a breach of contract, the Australian High Court did not engage in a discussion of that part of the *Andrews* ruling.<sup>45</sup>

### III. THE ENGLISH POSITION

Both *Cavendish Square Holding BV v. Talal El Makdessi* and *ParkingEye Limited v. Beavis* (“*Cavendish*”) “raise[d] an issue which has not been considered by the Supreme Court or by the House of Lords for a century, namely the principles underlying the law relating to contractual penalty clauses, or, as we will call it, the penalty rule.”<sup>46</sup> In their joint judgment, Lord Neuberger and Lord Sumption began by noting that the penalty rule in England is “an ancient, haphazardly constructed edifice which has not weathered well.”<sup>47</sup> At the same time, however, the Court stated that the distinction between a genuine pre-estimate of damages and a penalty clause has “remained fundamental to the modern law, as it is currently understood. The question of whether a damages clause is a penalty falls to be decided as a matter of construction . . . .”<sup>48</sup>

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<sup>42</sup> *Paciocco v Austl & NZ Banking Grp Ltd* [2016] HCA 28, para. 337 (27 July 2016) (Austl.) (citing *Hungerfords v Walker* (1989) 171 CLR 125 (Austl.)).

<sup>43</sup> *Id.* para. 347.

<sup>44</sup> *Andrews v Austl & NZ Banking Grp Ltd* (2012) 247 CLR 205 (Austl.).

<sup>45</sup> *Paciocco*, [2016] HCA 28, para. 120.

<sup>46</sup> *Cavendish Square Holding BV v. Talal El Makdessi* [2015] UKSC 67 [para. 1] (appeals taken from Eng.).

<sup>47</sup> *Id.* para. 3.

<sup>48</sup> *Id.* para. 9.

(i) *What is a penalty?*

In *Cavendish*, The House of Lords cited to *Scandinavian Trading Tanker Co. A.B. v. Flota Petrolera Ecuatoriana (The Scaptrade)*, in which Lord Diplock noted:

The classic form of penalty clause is one which provides that upon breach of a primary obligation under the contract a secondary obligation shall arise on the part of the party in breach to pay to the other party a sum of money which does not represent a genuine pre-estimate of any loss likely to be sustained by him as the result of the breach of primary obligation but is substantially in excess of that sum. The classic form of relief against such a penalty clause has been to refuse to give effect to it, but to award the common law measure of damages for the breach of primary obligation instead.<sup>49</sup>

Lord Diplock's statement, however, failed to answer two important questions that *Cavendish* discussed in detail. First, what are the circumstances under which a penalty clause is enlivened? Second, what makes a contractual provision penal?

In *Cavendish*, the House of Lords held that a penalty provision operates only upon a breach of contract and only in circumstances where the damage "bears little or no relationship to

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<sup>49</sup> *Cavendish Square Holding BV*, [2015] UKSC 67, para. 9 (quoting *Scandinavian Trading Tanker Co. A.B. v. Flota Petrolera Ecuatoriana* [1983] 2 AC 694 [702] (HL) (appeal taken from Eng.)).

the loss actually suffered by the plaintiff.”<sup>50</sup> The difficulty, however, exists in properly distinguishing between a genuine penalty clause and an onerous, or commercially imprudent, bargain. English courts have already recognized this problem. Both in England and Australia, however, courts have always held that absent certain circumstances, such as penalty clauses, contractual terms must be respected.

The more complicated question to answer is what makes a contractual provision penal. The House of Lords referred to two landmark decisions, *Clydebank Engineering & Shipbuilding Co. v. Don Jose Ramos Yzquierdo y Castaneda* (“*Clydebank*”) and *Dunlop*.<sup>51</sup> Interestingly, the Lords noted that the four tests formulated by Lord Dunedin in *Dunlop* unfortunately:

[A]chieved the status of a quasi-statutory code in the subsequent case law. Some of the many decisions on the validity of damages clauses are little more than a detailed exegesis or application of his four tests with a view to discovering whether the clause in issue can be brought within one or more of them.<sup>52</sup>

The House of Lords added that “the law relating to penalties has become the prisoner of artificial categorisation.”<sup>53</sup>

Ultimately, the Court concluded that the true test is “whether the impugned provision is a secondary obligation which

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<sup>50</sup> See *id.* para. 12 (quoting *Exp. Credits Guar. Dep't v. Universal Oil Prod. Co.* [1983] 1 WLR [399] (Gr. Brit.)).

<sup>51</sup> *Cavendish Square Holding BV v. Talal El Makdessi* [2015] UKSC 67 [para. 19] (appeals taken from Eng.) (citing *Dunlop Pneumatic Tyre Co. Ltd. v. New Garage and Motor Co. Ltd.* [1915] AC 79 (HL) (appeal taken from Eng.); *Clydebank Eng'g. & Shipbldg. Co. v. Don Jose Ramos Yzquierdo y Castaneda* [1905] AC 6 (HL) (appeal taken from Scot.)).

<sup>52</sup> *Id.* para. 22.

<sup>53</sup> *Id.* para. 31.

imposes a detriment on the contract-breaker out of all proportion to any legitimate interest of the innocent party in the enforcement of the primary obligation.”<sup>54</sup> As such, the question is not whether the challenged contractual provision is a pre-estimate of the loss, but whether it is penal. As already mentioned above, the High Court held that only a detriment imposed on a breach of contract can amount to a penalty,<sup>55</sup> and, as such, declined to follow the Australian holding laid out in *Andrews*.<sup>56</sup>

(ii) *The discussion*

It is important to understand the difference between the Australian and English treatment of penalty clauses, especially considering the fact that both courts relied on the same major precedents yet reached different conclusions. The Australian High Court followed *Andrews*, whereas the House of Lords was emphatic in their disagreement with the scope of the law, describing the decision as “a radical departure from the previous understanding of the law.”<sup>57</sup> In addition, *Cavendish* held that the rule against penalties was confined to cases arising out of contractual breach, whereas Justice Kiefel in *Paciocco* stated that rulings on penalty clauses are not restricted to breaches of contract.<sup>58</sup> Importantly, in *Paciocco*, the Court specifically noted that even if the sum in question—a late payment fee—is more than the cost, it is not a penalty, because the bank is expected to make legitimate profits for its expectant shareholders.<sup>59</sup>

Despite these convergent views, a better understanding of what constitutes a penalty clause has been achieved by both jurisdictions. It has been clearly stated that a fixed sum can be

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<sup>54</sup> *Id.* para. 32.

<sup>55</sup> *Id.* para. 12.

<sup>56</sup> *Id.* paras. 41-42.

<sup>57</sup> *Paciocco v Austl & NZ Banking Grp Ltd* [2016] HCA 28, para. 216 (27 July 2016) (Austl.); *Cavendish Square Holding BV v. Talal El Makdessi* [2015] UKSC 67 [para. 41] (appeals taken from Eng.).

<sup>58</sup> *Cavendish Square Holding BV*, [2015] UKSC 67, para. 12; *Paciocco*, [2016] HCA 28, para. 120.

<sup>59</sup> *Paciocco*, [2016] HCA 28, para. 30.

higher than the actual cost as the question of legitimate profits must be considered.<sup>60</sup> The phrase “unconscionable and extravagant” is used in both of the legal systems to describe a penalty clause.<sup>61</sup> What is considered to be “unconscionable and extravagant,” however, has not been defined but instead appears to be left to an interpretation of the facts of each case. Lastly, it seems that the “*Dunlop* tests” are still regarded as adequate, despite comments in *Cavendish* to the contrary.<sup>62</sup>

#### IV. THE CISG POSITION

In *Cavendish*, and arguably in Australia, the Court observed that the modern penalty rule is substantive in nature, and not procedural.<sup>63</sup> If the United Nations Convention on Contracts for the International Sale of Goods (“CISG”) is the governing law in a particular jurisdiction, then the question of whether a sum is penal in nature must be determined by the CISG. Both *Paciocco* and *Cavendish* stand for the proposition that a pre-determined amount of money, which becomes due in the event of a breach of a contract, even if higher than actual costs, is not necessarily penal.<sup>64</sup> It is the duty of a court or tribunal to determine its nature.

It has been established long ago at common law that penal clauses are unenforceable,<sup>65</sup> and the issue was not discussed in neither *Cavendish* nor *Paciocco*. The more important and more difficult question to answer is whether the CISG governs penalty clauses at all. From the outset, it must be noted that several

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<sup>60</sup> *Id.* para. 15.

<sup>61</sup> *Paciocco*, [2016] HCA 28, para. 29; *Cavendish Square Holding BV*, [2015] UKSC 67, para. 31.

<sup>62</sup> *Paciocco*, [2016] HCA 28, para. 29; *Cavendish Square Holding BV*, [2015] UKSC 67, para. 25.

<sup>63</sup> *Cavendish Square Holding BV v. Talal El Makdessi* [2015] UKSC 67 [para. 42] (appeals taken from Eng.).

<sup>64</sup> *Paciocco v Austl & NZ Banking Grp Ltd* [2016] HCA 28 (27 July 2016) (Austl.); *Cavendish Square Holding BV*, [2015] UKSC 67.

<sup>65</sup> See, e.g., DILAN THAMPAPILLAI, VIVI TAN & CLAUDIO BOZZI, *CONTRACT LAW TEXT AND CASES* 504 (2012).



authors have argued that penalty clauses are not governed by the CISG because its Article 4 states that the Convention does not apply to the “validity of the contract or any of its provisions.”<sup>66</sup> This presupposes both that the CISG does not govern the issue of penalty clauses and that the otherwise governing law, such as the common law, declares penalty clauses void.

First, this Article will demonstrate that the CISG does determine whether a contractual term is penal in nature. The determination of whether a sum is penal under the CISG is so interlinked with how a court or tribunal resolves this issue under otherwise governing law that recourse to domestic law is not needed. If the CISG governs, the question of whether a fixed sum is penal can be determined by its four corners, more specifically its Articles 8 and 74.<sup>67</sup> Second, this Article will address whether the CISG has the relevant remedies to manage such clauses without having to refer to domestic law.

Lastly, it is worth mentioning that the CISG governs only the sale of goods. Any issues with penalty clauses, therefore, can only be linked to a breach of contract. In this aspect, the CISG follows the English model, and not the Australian one.

(i) *Is the sum penal?*

As mentioned above, the answer to the question of whether a sum is penal must be found within the four corners of the CISG. The remedies for breach of contract by the buyer or seller have one common factor applicable to this issue, noted in Article 45 for the buyer and Article 61 for the seller.<sup>68</sup> Both Articles allow the aggrieved party to claim damages, as set out in Articles 74 through 77.<sup>69</sup> In addition, Articles 45 and 61 state that the aggrieved party “is not deprived of any right he may have to claim damages by

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<sup>66</sup> CISG, *supra* note 5, art. 4.

<sup>67</sup> *Id.* arts. 8, 74.

<sup>68</sup> *Id.* arts. 45, 61.

<sup>69</sup> *Id.* arts. 45, 61, 74-77.

exercising his right to other remedies.”<sup>70</sup> The prime solution, therefore, must lay within Articles 74 through 77. Article 74 notes that:

Damages for breach of contract by one party consist of a sum equal to the loss, including loss of profit, suffered by the other party as a consequence of the breach. Such damages may not exceed the loss which the party in breach foresaw or ought to have foreseen at the time of the conclusion of the contract, in the light of the facts and matters of which he then knew or ought to have known, as a possible consequence of the breach of contract.<sup>71</sup>

In brief, a court or tribunal is limited to award damages that do not exceed the actual loss, including loss of profit. This is a factual a determination. If the amount due upon a breach is predetermined and is more than the actual damages, it can potentially be classified as penal. However, it should also be noted that courts and tribunals, similarly to common law courts, can determine the relevant profit margin. Even if the fixed sum is more than the actual damages, the issue of the relevant profit calculation will allow a court a discretionary solution based on the evidence.

The second part of Article 74 causes some controversies. It notes that the damages cannot exceed the loss the party in breach foresaw at the conclusion of the contract.<sup>72</sup> If, however, a predetermined sum has been included into the contract, then it may have been foreseeable. Article 8 allows courts and tribunals to

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<sup>70</sup> *Id.* arts. 45, 61.

<sup>71</sup> *Id.* art. 74.

<sup>72</sup> *Id.*

consider parties' conduct to ascertain their intent.<sup>73</sup> The application of a party's in breach intent allows a court or tribunal to determine whether the consequences of a breach were foreseeable. In sum, taking Articles 8 and 74 into account, the CISG is perfectly capable of determining whether a sum is penal.

A decision by the Austrian Supreme Court is instructive on this point.<sup>74</sup> Damages in that case exceeded the price of the goods considerably.<sup>75</sup> The abstract of the case notes in brief that Article 74 follows the principle of foreseeability and full compensation and, as such, all losses that were foreseeable at the conclusion of the contract ought to be compensated.<sup>76</sup> More specifically, the Austrian Supreme Court held that:

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>77</sup>

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<sup>73</sup> *Id.* art. 8.

<sup>74</sup> Oberster Gerichtshof [OGH] [Supreme Court] Jan. 14, 2002, 7 Ob 301/01t (Austria), *translated in* CISG Case Presentation, PACE L. SCH. INST. OF INT'L COM. L. 2007, *translation at* <http://cisgw3.law.pace.edu/cases/020114a3.html>.

<sup>75</sup> *Id.*

<sup>76</sup> *Id.*

<sup>77</sup> *Id.*

As demonstrated, the concept of good faith and the general principle of reasonableness, not the fact that a sum exceeds the actual calculation of damages, allows courts and tribunals to decide whether a fixed sum is penal in nature. This reasoning is in line with the ruling in *Paciocco*.<sup>78</sup> Whether a term is “unconscionable and extravagant” should be the deciding factor in the determination of a clause’s nature.

(ii) *The discussion*

As discussed above, courts and tribunals ought to determine whether a fixed sum is penal in nature, pursuant to Article 8, which allows the consideration of parties’ intent, and the first sentence of Article 74, which, again, states that “[d]amages for breach of contract by one party consist of a sum equal to the loss, including loss of profit, suffered by the other party as a consequence of the breach.”<sup>79</sup> This indeed means that “damages must not place the aggrieved party in a better position than it would have enjoyed had the contract been properly performed.”<sup>80</sup> Courts, however, are well equipped to determine whether the damages place the aggrieved party in a better position or whether they equal to the loss of profit suffered. Opinions may diverge as to whether the CISG governs penalty clauses, but not as to whether courts and tribunals ought to determine whether the fixed sum is penal in nature, as this determination is substantive, and not procedural in nature. The general principles of the CISG—good faith and reasonableness—will aid them in that determination. Just because a contract notes a fixed sum, it is not automatically placed outside the sphere of the CISG.

Both the Australian and English cases discussed above struggled to explain the character of a penalty clause. Relying

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<sup>78</sup> *Paciocco v Austl & NZ Banking Grp Ltd* [2016] HCA 28 (27 July 2016) (Austl.).

<sup>79</sup> CISG, *supra* note 5, arts. 8, 74.

<sup>80</sup> John Y. Gotanda, *Calculation of Damages Under CISG Article 74*, para. 9 (Opinion No. 6) (last visited Aug. 30, 2017), <http://cisgw3.law.pace.edu/cisg/CISG-AC-op6.html>.

entirely on domestic law, each of the two jurisdictions took a similar, but not identical, path to resolve the question. It is untenable to argue that the determination between a sum being either a proper calculation of damages or a penalty clause is not clearly within the mandate of the CISG. Both Professor Graves and Hatchem<sup>81</sup> did not differentiate between the two important but distinct steps: the determination of the existence of a penalty clause and, secondly, the effect of a sum that is deemed to be penal.

It is this second step—what happens after a court or tribunal determines that the damages are penal in nature—that has led to a vigorous debate. Separate challenges have been mounted by both Pascal Hachem<sup>82</sup> and Bruno Zeller<sup>83</sup> in relation to the validity of penalty clauses, with both suggesting that it can be determined by reference to the general principles of the CISG.

Professor Graves correctly notes that once Article 4 comes into play, the issue as to the effect of a penalty clause must be governed by the otherwise applicable domestic law because Article 4 delegates questions of validity to domestic law.<sup>84</sup> This reasoning is based on the common law system, and not the civil law system. In contrast to common law, German and French law do not declare a penalty clause invalid.<sup>85</sup> As such, Article 4 is not enlivened. The question then becomes whether the CISG governs penalty clauses

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<sup>81</sup> Since 2016, Pascal Hatchem is an Associate at the Bär & Karrer Law Firm in Switzerland.

<sup>82</sup> 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).

<sup>83</sup> Bruno Zeller, *Penalty Clauses: Are They Governed by the CISG?*, 23 PACE INT'L L. REV. 1 (2011).

<sup>84</sup> CISG, *supra* note 5, art. 4 (“In particular, except as otherwise expressly provided in this Convention, it is not concerned with: (a) the validity of the contract or of any of its provisions or of any usage . . . .”); Graves, *supra* note 8, at 157.

<sup>85</sup> BÜRGERLICHES GESETZBUCH [BGB] [CIVIL CODE], arts. 340-41, *translation* at [http://www.gesetze-im-internet.de/englisch\\_bgb/englisch\\_bgb.pdf](http://www.gesetze-im-internet.de/englisch_bgb/englisch_bgb.pdf) (Ger.); CODE CIVIL [C. CIV.] [CIVIL CODE] arts. 1226-33 (Fr.).

when the French and German law is the otherwise governing law, or whether penalty clauses as such are not covered within the four corners of the CISG. Professor Graves has partially answered this question by noting that if a clause is valid, the CISG would arguably govern such a clause under Article 7(1) and its mandate to “promote uniformity;”<sup>86</sup> however, if the clause is invalid, the use of Article 7(1) “seems premature.”<sup>87</sup> Professor Graves reasons as follows:

[The CISG] does not expressly address fixed sums [either as liquidated damages or penalty clauses]. 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>88</sup>

Article 4 does indeed state that “except as otherwise expressly provided in this Convention, [this Convention] is not concerned with the validity of a contract or any of its provisions.”<sup>89</sup> At the same time, however, Article 4’s phrase “except as otherwise expressly provided in this Convention” limits this ‘validity exception’ “irrespective of whether [the issue] is characterized under domestic law as a question of validity.”<sup>90</sup> In addition,

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<sup>86</sup> Graves, *supra* note 8, at 165; CISG, *supra* note 5, art. 7(1).

<sup>87</sup> Graves, *supra* note 8, at 165.

<sup>88</sup> *Id.* at 155.

<sup>89</sup> CISG, *supra* note 5, art. 4(a).

<sup>90</sup> Graves, *supra* note 8, at 157 (citing Milena Djordjevic, *Declaration of Price Reduction under the CISG: Much Ado About Nothing?*, in UN CONVENTION ON CONTRACTS FOR THE INT’L SALE OF GOODS (CISG) 69, 69, ¶ 15 (Kroll, Mistelis & Viscasillas eds., 2011)).

Article 4 must be interpreted autonomously, and as Professor Schlechtriem<sup>91</sup> succinctly 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>92</sup>

Article 4 and its recourse to domestic law will not apply if the CISG provides a “functionally adequate solution” to the problem. The second sentence of Article 74, which states that the damages cannot exceed “the loss which the party foresaw or ought to have foreseen,”<sup>93</sup> with Article 8, which allows courts and tribunals to consider parties’ conduct to ascertain their intent,<sup>94</sup> supply such a “functionally adequate solution.” In order to determine what was foreseen by the parties prior to the conclusion of the contract, Article 8 must be consulted to see whether the party in breach knew the consequences of the breach. In conclusion, there will not be a gap in the CISG and Article 4 will not come into play.

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<sup>91</sup> Professor Schlechtriem was a leading scholar on the CISG and a Professor at the Freiburg University in Germany.

<sup>92</sup> COMMENTARY ON THE UN CONVENTION ON THE INTERNATIONAL SALE OF GOODS (CISG) 65-66 (Peter Schlechtriem & Ingeborg Schwenzer eds., 2d ed. 2005).

<sup>93</sup> CISG, *supra* note 5, art. 74.

<sup>94</sup> *Id.* art. 8.

Professor Graves does argue that the “functionally adequate solution,” as argued in this paper and prior work,<sup>95</sup> is incorrect. In brief, he reasons that:

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. In searching for a “functional equivalent” solution regarding any issues raised by penalty clauses, Zeller points us to Article 74. 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.<sup>96</sup>

Referring to the autonomy principle in Article 6,<sup>97</sup> Professor Graves also notes that “the parties may certainly

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<sup>95</sup> Zeller, *supra* note 83, at 8.

<sup>96</sup> Graves, *supra* note 8, at 161.

<sup>97</sup> CISG, *supra* note 5, art. 6 (“The parties may exclude the application of this Convention or, subject to article 12, derogate from or vary the effect of any of its provisions.”).



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>98</sup> Professor Graves is correct to state that party autonomy is limited and cannot overrule illegal contracts, as otherwise applicable law would not enforce the contract for public policy reasons.<sup>99</sup> However, the point is that a validity of a term—penalty clauses in this instance—does not affect the enforcement of a contract. The determination of whether a contract is valid is left to the governing law. As an example, a contract is valid under the CISG without consideration.<sup>100</sup> At common law, such a contract is invalid.<sup>101</sup>

(iii) *The jurisprudence*

If the foreseeability principle extends to losses that exceed the value of the contract, it will also extend to any other contractual clauses dealing with damages, including fixed sums. Article 8, in conjunction with Article 74, support this assertion.<sup>102</sup> This view is also in line with the Australian and English jurisprudence on penalty clauses.

Apart from Russia, a search of international CISG jurisprudence on penalty clauses does not provide many results. A notable exception is *Romania v. Netherlands* where the arbitrator of the Court of Arbitration of the International Chamber of Commerce, citing to Article 53 of the CISG,<sup>103</sup> which confirms the obligations by the buyer, noted that the seller was entitled to recover the penalty set forth in the contract.<sup>104</sup>

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<sup>98</sup> Graves, *supra* note 8, at 164.

<sup>99</sup> *Id.* at 164-65.

<sup>100</sup> CISG, *supra* note 5, arts. 12-24.

<sup>101</sup> THAMPAPILLAI, TAN & BOZZI, *supra* note 65, at 69-86.

<sup>102</sup> CISG, *supra* note 5, arts. 8, 74.

<sup>103</sup> *Id.* art. 53.

<sup>104</sup> *Romania v. Netherlands*, Case No. 8247, ¶ 11 (ICC Int'l Ct. Arb. 1996).

In Russia, courts are found to enforce penalty clauses by generally stating that “losses should be settled in accordance with the provisions of Art. 394 Civil Code, according to which losses should be recovered in the part not covered by the penalty. In the present case, these losses of [seller] *are* compensated by the sum of the recovered penalty.”<sup>105</sup> In effect, Russian courts are commenting that “a penalty constitutes a guarantee of the fulfilment of the obligation for the compensation of the creditor’s losses,” but, again, the penalty cannot be out of proportion.<sup>106</sup> Russian courts will allow payment of penalties reasoning that:

Vienna Convention does not regulate questions on recovery of penalties, however, it does not deprive the parties to an international sale and purchase contract of the possibility to reach an agreement on payment of a contract penalty. This sort of agreement on payment of contract penalties is to be regulated by the subsidiary applicable Russian civil legislation.<sup>107</sup>

One point is not in dispute. The CISG—like any other system—can, and must decide, whether a damages clause is penal. Because it is a matter of construction, such determination is made entirely within the four corners of the CISG. Both Article 8 and Article 4, which states that the scope of the Convention covers the

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<sup>105</sup> Russia v. United States, No. 165/2001, Arbitration Proceeding, Tribunal of International Commercial Arbitration at the Russian Federation Chamber of Commerce and Industry [Trib. Int’l Com. Arb. Rus. Fed. Cham. of Comm. & Indus.], ¶ 1 (Feb. 18, 2002), *translation at* <http://cisgw3.law.pace.edu/cases/020218r1.html>.

<sup>106</sup> Russia v. Germany, No. 134/2002, Arbitration Proceeding, Trib. Int’l Com. Arb. Rus. Fed. Cham. of Comm. & Indus., ¶ 1 (April 3, 2003), *translation at* <http://cisgw3.law.pace.edu/cases/030404r1.html>.

<sup>107</sup> Russian Federation Arbitration Proceeding, No. 115/2003, Trib. Int’l Com. Arb. Rus. Fed. Cham. of Comm. & Indus. (April 20, 2004), *translation at* <http://cisgw3.law.pace.edu/cases/040420r1.html>.

entire contract, including its formation and the rights and obligations of the parties, are of importance.<sup>108</sup> Penal clauses can be classified as such rights and obligations emanating from a contract.

As mentioned previously, in German and French law, the question of validity does not eventuate.<sup>109</sup> As such, the CISG is perfectly capable of resolving the issue of penalty clauses. As seen above, Russia represents a “halfway house between the common-law system and the civil law system.”<sup>110</sup> If the CISG can resolve the issue of penalty clauses when German or French law is the governing law, then why does Article 4 of the CISG<sup>111</sup> not allow this same outcome in common law cases, as well? Recall what Professor Schlechtriem said:

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>112</sup>

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<sup>108</sup> CISG, *supra* note 5, arts. 4, 8.

<sup>109</sup> BÜRGERLICHES GESETZBUCH [BGB] [CIVIL CODE], arts. 340-41, *translation* at [http://www.gesetze-im-internet.de/englisch\\_bgb/englisch\\_bgb.pdf](http://www.gesetze-im-internet.de/englisch_bgb/englisch_bgb.pdf) (Ger.); CODE CIVIL [C. CIV.] [CIVIL CODE] arts. 1226-33 (Fr.).

<sup>110</sup> Russian Federation Arbitration Proceeding, No. 115/2003, Trib. Int'l Com. Arb. Rus. Fed. Cham. of Comm. & Indus. (April 20, 2004), *translation* at <http://cisgw3.law.pace.edu/cases/040420r1.html>.

<sup>111</sup> CISG, *supra* note 5, art. 4.

<sup>112</sup> COMMENTARY ON THE UN CONVENTION ON THE INTERNATIONAL SALE OF GOODS (CISG) 65-66 (Peter Schlechtriem & Ingeborg Schwenzer eds., 2d ed. 2005).

In effect, Article 7's goal to "promote uniformity" in the application of the CISG has not yet been reached.<sup>113</sup>

Arguments have surfaced that the validity exception ought to be reconsidered.<sup>114</sup> However, as already discussed at length at various conferences, the Swiss Proposal has been rejected because the CISG as a convention cannot be amended.<sup>115</sup> That would mean a creation of a new convention, resulting in two separate ones, which is not desirable.<sup>116</sup> Further, "[t]here is a risk that a global undertaking to revise and to expand the CISG could have a chilling effect on further action by states to ratify or accede to the 1980 instrument."<sup>117</sup> In the same vein, a protocol to the CISG that would define validity is equally impossible.<sup>118</sup> What is possible is to take a global view and follow the mandate of Article 7 to "promote uniformity."

## V. CONCLUSION

Common law jurisprudence did not address the validity of penalty clauses. That issue, however, is settled law. What is new is the definition of what constitutes a penalty clause in the first place. In effect, that definition has been narrowed. As demonstrated, however, the two seminal cases from Australia and England are not in complete agreement.

With respect to the CISG, Professor Graves was correct to argue that the 'validity exception' of Article 4 of the CISG, if applicable, would suggest that the CISG does not govern the effect of penalty clauses in common law countries. The determination of whether a clause is penal, however, rests within the CISG. Many

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<sup>113</sup> CISG, *supra* note 5, art. 7(1).

<sup>114</sup> See, e.g., Jadranka Petrovic et al., *The Exclusion of the Validity of the Contract from the CISG: Does it still Matter?* 2 J. BUS. L. 101, 101 (2017).

<sup>115</sup> Keith Loken, *A New Global Initiative on Contract Law in UNCITRAL*, 58 VILLANOVA L. REV. 509, 509 (2013).

<sup>116</sup> *Id.*

<sup>117</sup> *Id.* at 513.

<sup>118</sup> Petrovic, *supra* note 114, at 112.

civil law countries, on the other hand, do not declare penalty clauses as void. Article 4 and its recourse to domestic law do not apply, however, because the CISG provides a “functionally adequate solution” through its Articles 8 and 74. In effect, this brings the CISG one step closer to its Article 7’s mandate to “promote uniformity.”