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AGREED SUMS IN CISG CONTRACTS*

This paper addresses penalty and liquidated damages clauses in contracts governed by the CISG. The Convention does not expressly deal with such clauses. The practical problems arising from this fact stem from the traditional differences in domestic legal systems. Contrary to Civil Law, penalty clauses are unenforceable in Common Law. As the CISG for questions of validity refers to the applicable domestic law, this causes divergent and unpredictable results. Based on comparative research a uniform treatment of such clauses can be found which is that where the CISG ap plies clauses are not unenforceable because they deter breach of contract.

Key words: *Penalty. Liquidated Damages. CISG. Validity. Comparative Law.*

1. Introduction

The issue addressed in this paper and that is currently discussed also by the CISG Advisory Council is that of fixed or agreed sums in contracts governed by the CISG. When using the term 'agreed sum', of course this does not refer to the purchase price but to clauses that in traditional terminology are called penalty or liquidated damages clauses.

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* This paper was given as a presentation at the 'Uniform Sales Law Conference The CISG at its 30th Birthday A Conference in Memory of Albert H. Kritzer' on 13 November 2010. The style of the presentation was not changed, only some basic refer ences were added. My remarks are based on the research I did for my broader work P. Hachem, *Agreed Sums Payable upon Breach of an Obligation Rethinking Penalty and Liquidated Damages Clauses*, Eleven Publishing, The Hague 2011 where more extensive references are provided for the issues raised in this paper. See also P. Hachem, "Fixed Sums in CISG Contracts", *The Vindobona Journal of International Commercial Law and Arbitration* 13/2009, 217 et seq.

The CISG does not address this kind of clauses and yet the number of cases having dealt with such clauses under the CISG in itself demonstrates that clarification of how to approach these clauses is necessary.

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Typically, such clauses are included where there is special interest in timely delivery of the goods or payment of the purchase price, adherence to a confidentiality or non-competition agreement. Furthermore, the law applicable – including the CISG – may not acknowledge certain detriments as "losses" and may therefore deny compensation for the breach of an obligation leading to such a detriment. This may, for instance, be the situation where chances are lost, reputation is damaged or legal costs are not compensated for. I should of course add that with regard to the first two types of detriments the CISG is far more advanced than domestic laws. Finally, the complexity of the contract may bring about serious problems in proving loss. In these cases, agreed sums reduce legal costs for producing evidence and the risk of losing litigation or arbitral proceedings due to the required standard of proof not being met.

These classic scenarios allow us to identify three essential functions of agreed sums, namely securing performance, compensation and liquidation of detriments incurred. Naturally, these functions overlap and the dividing line is not easily drawn.[1]

2. COMPARATIVE ANALYSIS

The starting point for the observations to be made here is the traditional difference between Common Law legal systems and Civil Law legal systems in approaching agreed sums.

2.1. Common Law

Building on developments originating in the 14th century Common Law legal systems do not accept agreed sums that they classify as penalties.[2] This means in traditional understanding that where an agreed sum

[1] See for details P. Hachem, supra (n. 1), 43 50.

[2] See for details P. Hachem, supra (n. 1), 34 38.

does not merely and genuinely pre-estimate the loss likely to occur upon breach, but where it is designed to deter the debtor from breach of contract, that clause will not be upheld.[3] In other words, where a clause functions as a mere means to secure performance and is not designed to compensate or liquidate detriments, it is inadmissible.

2.2. Civil Law, Mixed and Nordic Jurisdictions, International Instruments

On the other hand, building on Roman law heritage, Civil Law legal systems traditionally uphold all types of agreed sums independent of whether they are classified as penalty or liquidated damages.[4]

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[3] For details see P. Hachem, (2011), 37 et seq. The developments in England culminated in *Dunlop Pneumatic Tyre Company, Ltd v New Garage and Motor Company, Ltd* [1915] AC 79 (HL). In the USA *Banta v Stamford Motor Co*, Supreme Court of Errors Connecticut, 21 December 1914, 92 A 665 is considered the landmark decision in this context. The *Dunlop* case in particular provided guidance in other Common Law jurisdictions, see for Australia *Ringrow Pty Ltd v BP Australia Pty* [2005] HCA 71; Buthan see Sec 67(1) Commercial Sale of Goods Act; Ireland B. Doolan, *Principles of Irish Law*, Gill & MacMillan, Dublin 2003[6], 128; New Zealand J. Burrows, J. Finn, S. Todd, *Law of Contract in New Zealand*, LexisNexisNZ, Wellington 2007[3], para 21.2.6(a). A more guarded approach is taken by Canadian courts which require a certain element of oppressiveness to be present, see *Ontario Ltd v Torrey Springs II Associates Ltd Partnership*, Ontario Court of Appeals, 4 July 2005, 256 DLR (4th) 490. Exceptions to the general rule are Section 74 of the Indian and Pakistan Contracts Acts and Section 75 of the Malayan Contracts Act. However, the Malayan Supreme Court appears to interpret this provision as expressing the English rule, see *Selva Kumar A/L Murugiah v Thiagarajah A/L Retnasamy* [1995] 1 MLJ 817 harshly criticised by M. Mohd Danuri, M. Che Munaaim, L. Yen, "Liquidated Damages in the Malaysian Standard Forms of Construction Contract", *Construction Law Journal* 25, 103 et seq.

[4] See for Argentina Art 652 CC; Armenia Art 369 CC; Austria § 1336(1) CC; Belarus Art 311 CC; Belgium Art 1226 CC; Bolivia Art 532 CC; Brazil Art 408 CC; Bulgaria Section 92 OCA; Chile Art 1535 CC; China Art 114 Contract Law; Colombia Art 1592 CC; Costa Rica Art 708 CC; Croatia Art 350 Civil Obligations Act; Czech Republic § 544 CC; Ecuador Art 1578 CC; Egypt Art 223 CC; El Salvador Art 1406 CC; Georgia Art 417 CC; France Art 1226 CC; Germany § 339 CC; Greece Art 405 CC; Estonia § 158 Law of Obligations Act; France Art 1226 CC; Italy Art 1382 CC; Iraq Art 170 CC; Iran Art 230 CC; Japan Art 420 CC; Jordan Art 364 CC; Republic of Korea Art 398 CC; Latvia Art 1716 CC; Lebanon Art 266 Code of Obligations and Contracts; Lithuania Art 6.71 CC; Luxembourg Art 1226 CC; Macau Art 799 CC; Mexico Art 1841 CC; Moldova Art 624 CC; Mongolia Art 232 CC; the Netherlands Art 6.91 CC; Nicaragua Art 1985 CC; Panama Art 1039 CC; Paraguay Art 454 CC; Peru Art 1341 CC; Poland Art 481(1) CC; Portugal Art 812 CC; Romania Art 1066 CC; Russia Art 330 CC; Slovakia § 544 CC; South Korea Art 398 CC; Spain Art 1152 CC; Switzerland Art 160 CO; Syria Art 224 CC; Taiwan Art 250 CC; Uruguay Art 1363 CC; Uzbekistan Art 325 CC; Venezuela Art 1257 CC; Vietnam Art 422 CC; Yemen Art 348 CC. In Cambodia the 2008 draft for a Civil Code contains a provision on 'liquidated damages etc' in Article 403.

The Civil Law approach has also been adopted by the Mixed Jurisdictions[5] as well as by the Scandinavian legal systems. The same holds true for the UNIDROIT Principles of International Commercial Contracts,[6] the Principles of European Contract Law[7] and the Draft Common Frame of Reference prepared by the Study Group on a European Civil Code[8].

This liberal approach to agreed sums naturally is not unrestricted. All of the legal systems following this approach have established mechanisms to protect the debtor. Some of them, especially in Eastern Europe and Central Asia start out by establishing specific writing requirements for agreed sums.[9] A few legal systems, especially in the Ibero-American region, stipulate upper limits for agreed sums, for example, that a sum must not exceed 5% of the obligation to which it is attached.[10]

Far more prominent, however, is the mechanism employed by almost all of the legal systems upholding clauses independent of their type – which is the reduction of excessive sums.[11]

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[5] See for the Israel Art 15 Contracts (Remedies for Breach of Contract) Law (the draft of the Civil Code no longer uses the term 'liquidated damages' but in Articles 568, 569 only speaks of 'agreed upon compensation') Philippines Art 1229 CC; South Africa Arts 1, 3 Conventional Penalties Act (1962).

[6] See the respective Art 7.4.13 PICC 1994 and 2004.

[7] See Art 9:509 PECL.

[8] Art III. 3:712 DCFR.

[9] See for Armenia Art 370; Belarus Art 312(1) CC; Georgia Art 418(2); Lithuania Art 6.72 CC; Moldova Art 625(1) CC; Mongolia Art 232.3 CC; Russia Art 330 CC; Slovakia § 544(2) CC. Whether the new Civil Code of the Czech Republic will uphold this requirement currently contained in § 544(2) CC could not be confirmed at the time of writing.

[10] See for Bolivia Art 534 CC; Brazil Art 412 CC; Mexico Art 1843 CC; Portugal Art 811(3) CC.

[11] See for Argentina Art 656 CC; Armenia Art 372 CC; Austria § 1336(2) CC; Belarus Art 314 CC; Brazil Art 413 CC; Bulgaria Section 92 OCA; Chile Art 1539 CC; China Art 114 Contract Law; Colombia Art 1601 CC; Croatia Art 354 Civil Obligations Act; Ecuador Art 1587 CC; Egypt Art 224(2) CC; El Salvador Art 1415 CC; France Arts 1231, 1152 CC; Georgia Art 420 CC; Germany § 343 CC; Greece Art 409 CC; Estonia § 162 Law of Obligations Act; France Art 1152 CC; Italy Art 1384 CC; Iraq Art 171(2) CC; Iran Art 230 CC; Jordan Art 364(2) CC; Republic of Korea Art 398(2) CC; Lebanon Art 266(2) Code of Obligations and Contracts; Lithuania Art 6.73(2) CC; Luxembourg Arts 1231, 1152 CC; Macau Art 801 CC; Mexico Arts 1844, 1845 CC; Moldova Art 630(1) CC; Mongolia Art 232(8) CC; the Netherlands Art 6.94 CC; Panama Art 1041 CC; Paraguay Art 459 CC; Peru Art 1346 CC; Poland Art 484(2) CC; Portugal Art 812 CC; Romania Art 1070 CC; Russia Art 333 CC; South Korea Art 398(2) CC; Spain Art 1154 CC; Switzerland Art 163 CO; Syria Art 225(2) CC; Taiwan Art 252 CC; Uzbekistan Art 326 CC; Venezuela Art 1260 CC; Yemen Art 354 CC. An unusual rule can be found in Article 403(3) of the 2008 draft for a Cambodian Civil Code which first holds that the agreed amount of damages must not be modified but adds that this may be done where the damage sustained is grossly higher or lower than the amount fixed.

3. AGREED SUMS IN CISG CONTRACTS POSSIBLE SOLUTIONS

Against this background, it is the purpose of this paper to outline the model the author believes best suited to achieve a certain level of uniform treatment of agreed sums in contracts governed by the CISG despite the remaining differences amongst the individual legal systems or families.[12]

It should be noted that the author had the honour to report this model also to the CISG Advisory Council in November 2010[13] and naturally hopes that at the end of the discussion it will be looked upon favourably.

3.1. General

The starting point is acknowledging that the CISG does not address agreed sums. Indeed, in the drafting process a proposal to do so was rejected on the grounds that it was too difficult to find a solution.

It should, however, be noted that these difficulties seem to have mysteriously disappeared three years after the CISG was finalised. In 1983 UNCITRAL was able to publish the Uniform Rules on Contract Clauses for an Agreed Sum Due upon Failure of Performance.[14] The fact that these were not established as a Convention but as a recommendation to domestic legislators may explain a fair portion of why seemingly no greater difficulties were encountered in the drafting process.

In addition these rules not only overcame traditional domestic distinctions already about thirty years ago, but for their main part contain solutions that are still convincing and display a high degree of clarity. It is to be regretted that this work appears to not have been fully appreciated in the drafting of the UNIDROIT Principles of International Commercial Contracts, the Principles of European Contract Law and the Draft Common Frame of Reference. All of them contain only a fragment of the law of agreed sums and are in this respect quite disappointing seeing that UNCITRAL had provided them with at least arguable suggestions of how this area of the law could have been developed at the international level, which were neither confirmed nor rejected.

In any case, with regard to the CISG it is undisputed that Article 6 CISG allows for the incorporation of an agreed sum into the contract.[15] It

[12] Some of these aspects are briefly outlined in P. Hachem, (2009), 217 et seq. The comprehensive analysis is laid down in P. Hachem, (2011), Chapter VI.

[13] Meeting of the CISG Advisory Council on 10 November 2010, Belgrade.

[14] Full text available at *http://www.uncitral.org/pdf/english/texts/sales/contract/vol14 p272 273 e.pdf.*

[15] See instead of all Foreign Trade Court of Arbitration Attached to the Serbian Chamber of Commerce, 15 July 2008, CISG online 1795; I. Schwenzer, P. Hachem, "Art.

is also undisputed that the CISG governs the formation of agreed sums.[16] The remaining difficulties primarily pertain to the protection of the debtor.

3.2. Protection of the Debtor

3.2.1. General

It is clear that by virtue of Article 4 sentence 2(a) CISG the Convention does not govern the validity of agreed sums. This raises the question whether from the perspective of the CISG the protection of the debtor is a question of validity. Straightforwardly put: Yes it is.

Independent of whether the debtor is protected by not upholding agreed sums classified as penalties, whether the debtor is protected by reducing excessive sums or whether the debtor is protected by fixed upper limits to agreed sums, the question is always, whether and to what extent an agreed sum is upheld. From the perspective of the CISG that is a matter of validity.

The domestic mechanisms for the protection of the debtor therefore remain applicable. The exception to this are domestic formal requirements for agreed sums which are pre-empted by Article 11 CISG.

3.2.2. Application of Domestic Tests to CISG Contracts

The mere fact that domestic mechanisms on the protection of the debtor apply also to agreed sums in contracts governed by the CISG does not necessitate that the Convention is without influence on the way in which these domestic mechanisms are applied. It is well established in the field of standard terms that domestic mechanisms dealing with their validity must be applied in light of an international standard.[17] This standard is then to be derived from the policies embodied in the CISG. In my opinion it is unjustifiable to restrict this approach to standard terms. Rather, it must be used for all terms, including agreed sums.

To be clear on this point: It is submitted that the excessiveness of an agreed sum must not be determined by domestic policies but by the policies of the CISG. It is further submitted that whether a sum is a genuine pre-estimate of loss must not be determined by domestic policies but by the policies of the CISG.

4", *Commentary on the UN Convention on the International Sale of Goods* (eds. P. Schlechtriem, I. Schwenzer), Oxford University Press, Oxford 2010[3], para 17.

[16] See instead of all *ibid.* citing references.

[17] See F. Ferrari, "Art. 4', *Kommentar zum Einheitlichen UN Kaufrecht* (eds. P. Schlechtriem, I. Schwenzer), C.H.Beck, Munich 2008[4], para 22; concurring I. Schwenzer, P. Hachem, para. 44; P. Hachem, (2009), 223.

3.2.2.1. Policies of the CISG

To determine the policies of the CISG we must look to its provisions and interpret them as required by Article 7(1) CISG in a manner that is acceptable to different legal systems of different legal traditions.

The starting point is Article 6 CISG. According to the unanimous view, this provision embodies the general principle of freedom of contract,[18] which is even considered to be one of the principles upon which the entire Convention is based in the sense of Article 7(2) CISG. This means that we are to make sure that when applying domestic mechanisms, we must be dedicated to the fact that we are interfering with the intention of professional market actors operating on an international scale.

Moving on to Articles 46 and 62 CISG we see that both parties may claim specific performance under the Convention. This means that the Convention is familiar with the principle of *pacta sunt servanda*, that is that contracts must be kept.

Finally, we must look to Article 74 CISG, the general provision on the calculation of damages. Here, it is undisputed and confirmed by the CISG Advisory Council in Opinion No. 6 that the CISG provisions on damages express the general principle of full compensation.[19]

Thus, in summary, the application of domestic mechanisms for the protection of the debtor against agreed sums must respect as far as possible the will of the parties; it must respect the principle of *pacta sunt servanda* and it must respect party attempts to ensure full compensation by way of an agreed sum.

3.2.2.2. Deterring Breach of Contract by Agreed Sums in CISG Contracts

It is at this point that we encounter the question whether parties may incorporate agreed sums that are designed to deter breach of contract and to compel the debtor to perform. You will remember that this is the dividing line between traditional Civil Law and Common Law approaches.

It is the author's position that agreed sums in contracts governed by the CISG do not fail any domestic mechanism simply because of the fact that they seek to induce performance by the debtor.

For the Civil Law legal systems it is easy to accept an international standard that vests the parties with the freedom to induce performance by

[18] See instead of all I. Schwenzer, P. Hachem, supra (n. 17), Art. 6, para. 8 citing references.

[19] See CISG AC, Opinion No. 6: *Calculation of Damages Under Article 74* (Rap porteur: Gotanda), Black Letter Rule 1.

way of an agreed sum. For Common Law legal systems drawing such an inference from the CISG for the practical application of their traditional genuine pre-estimate of loss test is less obvious. However, in my opinion, concerns of that nature today can be accommodated.

First of all, the traditional Common Law approach is increasingly challenged. For reasons of time I may simply present you a highlight reel of the statements made to that effect. For example, Lord DIPLOCK stated: "I will make no attempt, where so many others have failed, to rationalise this common law rule".[20] The well known American Court of Appeal Judge RICHARD POSNER is even more outspoken. In his view the traditional Common Law approach is an "anomaly",[21] its underlying ratio "mysterious"[22] and "one of the abiding mysteries of Common Law"[23] which turns out to be an "anachronism especially in cases in which commercial enterprises are on both sides of the contract"[24]. Other statements both in court decisions and scholarly writings speak of a blatant interference with the freedom of contract[25] or quite simply of an accident of legal history[26].

Second, the principle of *pacta sunt servanda* has seen increasing strengthening throughout the Common Law world. This finding in and of itself warrants a separate presentation, and it is hard for me to resist going into details now.[27] For present purposes, however, I shall only briefly draw your attention to the fact that the so called doctrine of efficient breach of contract has never found its way into practice and is by what I perceive to be the majority view rejected also in academia as the delusion that it is. Furthermore, the traditional disdain for the concept of specific performance has lessened at least in the United States and in Canada. And although in England it is only rarely granted, the discussion has been re-

[20] *Robophone Facilities Ltd. v. Blank* [1966] 1 WLR 1428 at 1446.

[21] See *XCO International, Inc v. Pacific Scientific Company*, US Court of Appeals (7th Cir), 24 May 2004, 369 F3d 998 at 1001: 'Courts don't review the other provisions of contracts for reasonableness; why this one?'

[22] See *XCO International, Inc v. Pacific Scientific Company*, US Court of Appeals (7th Cir), 24 May 2004, 369 F3d 998 at 1001.

[23] See *XCO International, Inc v. Pacific Scientific Company*, US Court of Appeals (7th Cir), 24 May 2004, 369 F3d 998 at 1001.

[24] See *XCO International, Inc v. Pacific Scientific Company*, US Court of Appeals (7th Cir), 24 May 2004, 369 F3d 998 at 1002. Already at p 1001 Judge Posner had point ed out that 'ironically, it is the larger firm, PacSci, that is crying 'penalty clause".

[25] *Elsley v. JG Collins Insurance Agencies Ltd.*, Supreme Court of Canada, 7 March 1978, [1978] 2 SCR 916 at 937 per Judge Dickinson.

[26] U. Mattei, "The Comparative Law and Economics of Penalty Clauses in Con tracts", *American Journal of Comparative Law* 43/1995, 433

[27] See for details on the modern tendencies in Common Law jurisdictions P. Hachem, (2011), 83 115.

vived in recent times also in England, in particular regarding long-term contractual relationships. In any case, all of the uniform projects acknowledge the availability of the claim for specific performance and this does not seem to have raised particular difficulties in the drafting process. For the United States specifically it is worth mentioning a 1990 survey of 1400 court decisions where the author concludes that granting specific performance tends to be the rule rather than the exception[28] – twenty years ago that is and the trend has not been reversed.

Third, the understanding of the principles underlying the law of damages has shifted from a pure economic perspective to one that focuses on the protection of performance.[29] In Canada punitive damages are now available in case of bad faith breach of contract independent of whether a tort has been committed.[30] In the United States such tendencies are discernible in the fields of insurance and employment law. In England a significant view anticipates this to be an at least inevitable if not welcome development of English law in the future.[31] Indicative of this development is the decision of the English House of Lords in *Attorney-General v. Blake*.[32] Indeed the facts of this case involving a side switching secret agent who made a profit by divulging internal information in his autobiography thereby breaching his confidentiality obligation are unusual. However, this does not change the fact that their Lordships stripped this "notorious self-confessed traitor"[33] of the profit he had derived from the breach although no loss had occurred.

In light of these three developments it is submitted that today it is acceptable for Common Law legal systems to infer from the CISG that it vests parties with the freedom of contract under Article 6 to strengthen the principle of *pacta sunt servanda* in Articles 46 and 62 by making use of an agreed sum that in the same way as Article 74 protects performance.

Hence, in the author's opinion an agreed sum in a contract governed by the CISG cannot be struck out by the genuine pre-estimate of

[28] D. Laycock, "The Death of the Irreparable Injury Rule", *Harvard Law Review* 103/1990, 689

[29] For details see P. Hachem, (2011), 89 101.

[30] The leading case is *Whiten v. Pilot Insurance Co*, Supreme Court of Canada, 22 February 2002, [2002] 1 SCR 595.

[31] See R. Cunnington, "Should Punitive Damages be Part of the Judicial Arsenal in Contract Actions?", *Legal Studies* 26/2006, 377; J. Edelman, "Exemplary Damages for Breach of Contract", *Law Quarterly Review* 117/2001, 539; A. Burrows, *Remedies for Torts and Breach of Contract*, Oxford University Press, Oxford 2003[3], 409 et seq.

[32] [2001] 1 AC 268 (HL).

[33] Quote from *Attorney General v. Blake* [2001] 1 AC 268 (HL) at 275 per Lord Nicholls of Birkenhead.

loss test on the sole grounds that it is designed to deter breach of contract and compel the debtor to perform.

The model suggested here in fact enables Common Law judges and arbitrators to escape domestic constraints in the context of international sales contracts without forcing them to abandon domestic structures. This takes care both of their concerns as to the present state of their domestic law as well as of their concern that they do not see themselves in the position to change the traditional domestic situation, as at least in the international sale of goods approximation to their preferred position is possible.

On a broader scale, the model advocated here promotes the harmonisation of the outcomes of validity questions relating to clauses that are standard features in sales contracts.

4. CONCLUSION

The model of dealing with agreed sums suggested here asks for strict approach to the uniform application of the CISG under Article 7(1) by maintaining the policies of the Convention also where it is necessary of have domestic law interfering. It further requires to be strict about the purpose of the Convention to help approximating, harmonising and converging domestic systems in the area of international sales.