

II. INTERNATIONAL CONTRACT PRACTICES

Report of the Working Group on International Contract Practices on the work of its first session (Vienna, 24–28 September 1979) (A/CN.9/177)*

CONTENTS

	<i>Paragraphs</i>
I. INTRODUCTION	1–9
II. GENERAL DISCUSSION	10–13
III. CONSIDERATION OF DRAFT RULES BY THE WORKING GROUP	14–39
IV. FUTURE WORK	40–43

I. INTRODUCTION

1. At its twelfth session, the United Nations Commission on International Trade Law decided to re-name its Working Group on the International Sale of Goods as the Working Group on International Contract Practices,¹ and requested the Working Group to consider the feasibility of formulating uniform rules on liquidated damages and penalty clauses applicable to a wide range of international trade contracts.²

2. The Working Group is currently composed of the following States members of the Commission: Austria, Brazil, Czechoslovakia, France, Ghana, Hungary, India, Japan, Kenya, Mexico, Philippines, Sierra Leone, Union of Soviet Socialist Republics, United Kingdom of Great Britain and Northern Ireland and the United States of America.

3. The Working Group held its first session at the Hofburg, Vienna, from 24 to 28 September 1979. All members of the Working Group were represented except Ghana, Hungary, Kenya, Philippines and Sierra Leone.

4. The session was attended by observers from the following States members of the Commission: Chile, Egypt, German Democratic Republic, Greece and Indonesia.

5. The session was also attended by observers from the following Member States of the United Nations: Argentina, China, Iraq, Kuwait, Pakistan, Poland, Romania, Thailand, Uruguay and Venezuela.

6. The session was attended by an observer from the following international organization: Council of Europe.

7. The Working Group elected the following officers:

Chairman Mr. J. Barrera-Graf (Mexico)
Rapporteur Mr. M. Cuker (Czechoslovakia)

8. The following documents were placed before the session:

(a) Report of the Secretary-General entitled "Liquidated Damages and Penalty Clauses" (A/CN.9/161)* submitted to the twelfth session of the Commission;

(b) A publication (in English and French only) of the Council of Europe entitled "Penal Clauses in Civil Law" containing the text of resolution 78 (3) adopted by the Committee of Ministers of the Council of Europe on 20 January 1978, with an Explanatory Memorandum;

(c) The text (in French only) of the Benelux Convention on Penal Clauses signed at the Hague on 26 November 1973.

9. The Working Group adopted the following agenda:

- (a) Election of officers;
- (b) Adoption of the agenda;
- (c) Consideration of the feasibility of formulating uniform rules on liquidated damages and penalty clauses applicable to a wide range of international trade contracts;
- (d) Other business;
- (e) Adoption of the report.

II. GENERAL DISCUSSION

10. The Working Group took note of the decision taken by the Commission at its twelfth session (18–29 June 1979) by which the Group was requested "to consider the feasibility of formulating uniform rules on liquidated damages and penalty clauses applicable to a wide range of international trade contracts", and to report its conclusions to the Commission at a future session.³

11. After a general discussion on the main differences obtaining in the Common Law and the Civil Law systems in respect of the validity and enforceability of agreements

* 4 October 1979.

¹ Report of the United Nations Commission on International Trade Law on the work of its twelfth session (1979), *Official Records of the General Assembly, Thirty-fourth Session, Supplement No. 17* (A/34/17), para. 126 (Yearbook . . . 1979, part one, II, A).

² *Ibid.*, para. 31 (Yearbook . . . 1979, part one, II, A).

* Yearbook . . . 1979, part two, I, C.

³ Report of the United Nations Commission on International Trade Law on the work of its twelfth session (1979), *Official Records of the General Assembly, Thirty-fourth Session, Supplement No. 17* (A/34/17), paras. 30 and 31 (Yearbook . . . 1979, part one, II, A).

providing for damages and penalties and of the purposes which such agreements seek to achieve, the Working Group considered the following issues:

- A. Possible scope of rules applicable to such agreements.
- B. The accessory nature of such agreements.
- C. The relationship between the right to obtain performance of a contractual obligation and performance of agreements accessory to it.
- D. The relationship between the right to obtain performance of the accessory obligation and damages for breach of the contractual obligation to which it is accessory.
- E. Limitations on the freedom of the parties to stipulate a sum of money by way of penalty, and the power of courts and arbitral tribunals to modify the amount of the sum stipulated.

12. The Working Group was of the view that it would be premature to decide what should be the character of the proposed rules (e.g. model clause, model law or convention). One representative suggested that work should be directed towards the preparation of model clauses.

13. The Working Group requested the Secretariat to prepare preliminary draft rules on these issues, taking into account the views expressed thereon during the general discussion, and to submit the draft rules for consideration by the Group. The draft Rules set forth below were accordingly submitted by the Secretariat to the Working Group.

III. CONSIDERATION OF DRAFT RULES BY THE WORKING GROUP

14. A. *Possible scope of rules applicable to such agreements*

Draft Rule 1

"These Rules apply where the parties to a contract have agreed (in writing) that, in the event of failure by the promisor (debtor) to perform his obligation, or a specified obligation, under the contract, he will pay to the promisee (creditor) or forfeit to him a sum of money (or perform a specified act) (, whether by way of compensation or penalty or both)."

15. The Working Group was generally agreed that the proposed Rules should apply to international trade contracts only, but that it should be considered at a later stage of the work whether certain specific contracts or obligations should be excluded from the application of the Rules. Furthermore the Rules should apply to agreements in international trade contracts, irrespective of whether such agreements envisaged the payment of a sum of money by way of compensation for loss suffered, or by way of penalty in order to coerce the debtor to perform.

16. The Working Group was agreed that the character of the proposed Rules, and the circumstances under which they would become applicable to a particular contract, were related issues. Thus if the proposed Rules were drafted in the form of model clauses, they would only become applicable by agreement of the parties to a contract to that effect. The circumstances under which the Rules would become applicable should therefore only be finally defined after the character of the Rules was determined.

17. The Working Group was agreed that the Rules should only regulate cases where parties had agreed that, in the event of failure by the promisor to perform his obligation under the contract, he would pay to the promisee, or forfeit to him, a sum of money. Therefore, the Rules should not regulate clauses stipulating something other than the payment of a sum of money, such as the performance of an act. Three representatives expressed the view that the Rules should also apply to cases where the stipulation envisaged the performance of an act other than the payment of money, such as the forfeiture of property.

18. Views were expressed both in favour of including, and in favour of deleting, the phrases "in writing" and "whether by way of compensation or penalty or both". The Working Group was agreed that these questions should be considered at a later stage, and therefore maintained these phrases between brackets.

19. There was general agreement that the text should clearly state that the Rules were applicable, not only to cases of a promise to pay, or forfeiture of, a sum of money on total failure by the promisor to perform his obligations, but also to cases where the breach consisted of defective or partial performance. The Secretariat was also requested to clarify the meaning of the phrase "to perform his obligation, or a specified obligation, under the contract", contained in the draft Rule.

20. B. *The accessory nature of such agreements*

Draft Rule 2

"Unless the Parties have agreed otherwise, the promisee is not entitled to enforce the agreement if the promisor is not liable for his failure to perform the obligation (is not in breach of the obligation) to which the agreement relates."

21. The Working Group was of the view that the agreement, unless it clearly provided otherwise, should be considered as accessory to the contractual obligation to which it related. Therefore, if the promisor was not liable for his failure to perform the contractual obligation because of exemption based on *force majeure* or the like, the promisee was not entitled to claim the stipulated sum. However there was general agreement that, as the opening words of the draft Rule indicated, parties were at liberty to provide that the promisee was entitled to claim the stipulated sum by reason of the fact that the contractual obligation was breached even though the promisor was not liable for such breach. The Group was agreed that, in such a case, the claim of the promisee should be subject to any mandatory limitations set forth by the Rules regarding the enforceability of an agreement.

22. C. *The relationship between the right to obtain performance of a contractual obligation and performance of agreements accessory to it*

Draft Rule 3

"(1) Unless the parties have agreed otherwise, the promisee is not entitled to enforce the agreement if he requests performance of the obligation to which the agreement relates.

“(2) The provision of paragraph (1) of this Rule does not apply if the agreement relates to delay in performance.”

Draft Rule 4

“The promisee may, at his option, either enforce the agreement or request performance of the obligation to which the agreement relates.”

23. There was a divergence of views as to what were the appropriate principles to regulate this issue. The opinion was expressed that draft Rule 3 set forth acceptable principles. The promisee should in general not be entitled both to enforce due performance of a contractual obligation and to claim the sum of money stipulated because the result would be excessively harsh on the promisor. However, under one view, parties could agree that the promisee should be so entitled. Under another view, such an agreement might produce such harsh results as to invoke rules on invalidity.

24. The view was expressed that the appropriate principles were contained in the following text:

“Payment of an agreed sum does not exempt the promisor from performance of the obligation, for breach of which he has paid the agreed sum, unless the parties had agreed otherwise.”

25. In support of this text it was noted that the essential purpose of the contract was performance by the promisor, and that the object of the stipulated sum payable on breach was to compensate the promisee for loss resulting from the breach. It was therefore not unfair if the promisee were given the right both to obtain proper performance and to obtain the stipulated sum. It was stated that the proposed rule reflected the principle that the payment of the sum stipulated should not in itself nullify the contract. The rule would be particularly appropriate in cases where the breach consisted of delay in performance, or partial or defective performance.

26. The Working Group, after deliberation, decided to retain the proposed text as a variant of draft Rule 3 for later consideration.

27. In regard to draft Rule 3, the view was also expressed that a mere request for performance of the obligation to which the agreement relates should not be sufficient to disentitle the promisee to enforce the agreement. He should only be so disentitled if he obtains performance of the obligation to which the agreement relates.

28. The Working Group decided to delete draft Rule 4 because the principle set forth therein was already embodied in draft Rule 3.

29. D. *The relationship between the right to obtain performance of the accessory obligation and damages for breach of the contractual obligation to which it is accessory*

Draft Rule 5

Variant A

“(1) Unless the parties have agreed otherwise, the promisee is not entitled to claim damages but can only enforce the agreement.

“(2) Nevertheless, the promisee is not entitled to a sum of money in excess of the sum stipulated in the agreement or in excess of the amount of damages which he could have claimed if no such sum had been stipulated, whichever is the larger.”

30. Divergent views were advanced on the question whether the normative rule should state that, where a penalty clause or liquidated damages clause had been stipulated, the promisee could not claim damages. Under one view the draft Rules should set forth this principle. Under another view the purpose of such a clause was not only to pre-estimate damages but also to coerce performance of the contract. Hence, if the promisor breached the contract, the sum stipulated could be claimed by the promisee, but the contract should remain enforceable and damages could be claimed for its breach.

31. In reply to this view, it was stated that such a rule could lead to unsatisfactory consequences, as in a case where the stipulated sum represented a pre-estimate of damages and because of non-performance the promisee obtained payment both of full damages and the stipulated sum. Under yet another view if the amount of the damage suffered was in excess of the sum stipulated, the promisee should be allowed to claim the amount of damages not covered by the sum stipulated.

32. The Working Group was unable to reach consensus on which norm should be adopted. However there was agreement that, whatever norm would be adopted, the parties should have the faculty to modify such norm by common agreement, it being understood that standards by which the validity or appropriateness of the clause would be judged (future draft Rule 6) would apply.

33. The Working Group decided to postpone to a later stage the discussion of paragraph (2) of draft Rule 5.

34. In view of this lack of consensus, the Working Group decided that, for the time being, draft Rule 5 should set forth three variants:

Variant A

The text as set out above.

Variant B

“(1) In case of non-performance of the principal obligation the promisee is entitled to obtain the sum of money or to request the performance of the act as stipulated in the penalty clause. The parties may agree that such sum of money or such act constitute a minimum and that the promisee may claim full compensation. In such a case the promisee must prove his actual loss before the competent court.

“(2) The parties may agree that the sum of money stipulated by the agreement constitutes a maximum amount and that the promisor may obtain a reduction of the sum stipulated to an amount of damages actually suffered by the promisee. In such a case the promisor must prove his claim before the competent court.”

Variant C

“Unless the parties have agreed otherwise, the promisee, in addition to the sum stipulated, can obtain

damages in respect of the failure to perform the contractual obligation to the extent that damages exceed the amount of the sum stipulated."

35. With respect to variants B and C, two representatives stated that they could not support the rules contained therein on the ground that they removed the benefit, inherent in a liquidated damages clause, of certainty about the extent of possible future claims for damages.

36. The view was expressed that the provisions of draft Rules 2, 3 and 5 introduced by the phrase "unless the parties have agreed otherwise", might imply that such agreements in all circumstances were reasonable and valid. According to this view, in some circumstances, such agreements could be excessively harsh and should not be enforced. It was suggested that, in order to avoid possible misinterpretation, the substance of draft Rules 2, 3 and 5 should be combined in a single rule as follows:

"Unless the parties have agreed otherwise, the agreement (described in Rule 1) shall be construed as follows:" (draft Rules 2, 3 and 5 to follow without the opening words "unless the parties have agreed otherwise").

37. E. *Limitations on the freedom of the parties to stipulate a sum of money by way of penalty, and the power of courts and arbitral tribunals to modify the amount of the sum stipulated*

The Working Group held a preliminary discussion in respect of the mandatory limitations which the Rules might contain. There was general agreement that the draft Rules should contain provisions regarding the enforceability and validity of an agreement stipulating that the party in breach of a contractual obligation was bound to pay a specified sum of money. However no consensus could be reached as to the degree of control a court or arbitral institution should exercise. According to one view the sum stipulated by the parties should not be subject to modification by a court or arbitral institution; according to another view the only sanction the Rules should impose should be the invalidity of the agreement in cases where the sum stipulated was manifestly excessive in relation to the damages which the parties, at the time of the stipulation of the agreement, could foresee as the consequence of breach of the contractual obligation. Under this view, the promisee, in the event of the agreement having been declared void, should still be entitled to claim damages.

38. The Working Group, after deliberation, decided to retain the following texts for future consideration:

Draft Rule 6

Variant A

"An agreement stipulating a sum payable on breach of the contract shall be void if it is grossly excessive in relationship to both (a) the harm that could reasonably have been anticipated from the breach, and (b) the actual harm caused thereby. The foregoing relationships are not excessive to the extent that such harm cannot be precisely predicted or established."

Variant B

"The sum stipulated may be reduced by the court when it is manifestly excessive, but only where such sum

did not constitute a genuine pre-estimate by the parties of the damage likely to be suffered by the promisee."

Variant C

"A provision to the effect that a court should not have the power to modify the sum stipulated."

Variant D

"Any penalty clause the amount of which, at the time when it was stipulated, was manifestly excessive in relation to the damages which could be foreseen as the consequence of non-fulfilment of the obligation, is deemed not to have been written."

39. It was observed that the words "manifestly excessive", contained in some of the proposed variants, could introduce uncertainty as to the circumstances in which courts would exercise their discretion. While it was agreed that the decision as to whether the sum stipulated was manifestly excessive would depend on questions of fact, the Group requested the Secretariat to propose, for consideration at a future session, an appropriate wording.

IV. FUTURE WORK

40. There was general agreement that, while the discussion at the present session had revealed a divergence of views on certain issues, further work by the Working Group on the subject of liquidated damages and penalty clauses was justified. It was noted that the provisions of Resolution 78 (3) of the Council of Europe, and those of the Benelux Convention on the Penalty Clause, on which divergent views had been expressed, were directed to the unification of national laws governing a wide variety of domestic transactions. Greater consensus might be achieved on a set of rules designed to regulate liquidated damages and penalty clauses in selected types of international trade contracts.

41. The Working Group was therefore of the view that the Secretariat should undertake a further study to be submitted to the next session of the Working Group focusing on the following issues:

(a) The manner in which liquidated damages and penalty clauses are drafted and used in various types of international trade contracts;

(b) The particular types of international trade contracts which might usefully be regulated by uniform rules;

(c) The legal difficulties encountered in the use of liquidated damages and penalty clauses, as shown by court and arbitral decisions.

Such a study, apart from its value in the further work of the Working Group, would be useful for commercial and legal circles.

42. The Working Group was of the view that the Secretariat could submit to the next session of the Working Group a revised set of draft rules for regulating liquidated damages and penalty clauses, if the further work of the Secretariat disclosed the desirability of drafting such a revised set of rules.

43. The Working Group decided to recommend to the Commission the holding of a further session of the Working Group, leaving the date of this session to be decided by the Commission at its thirteenth session.